Second Edition

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As per The Companies Act, 2013 including Rules 2014 and 2015

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Preface to the Second Edition

In the last few years, there have been enormous changes in accounting procedures and disclosures of companies. The Companies Act, 2013 has been implemented, and the different accounts are to be prepared as per the provisions of the Accounting Standards. Many Universities have revised their respective syllabi to accommodate the changes brought in by The Companies Act, 2013 and the Accounting Standards.

In this edition, chapters related to Company Accounts have been thoroughly revised as per the provision of The Companies Act, 2013, Companies Rules 2014 and 2015 and the regulations prescribed by SEBI. Special importance has been given to the following chapters.

1. Company Final Accounts
2. Redemption of Preference Shares
3. Buy Back of Shares
4. Employees Stock Option Scheme/Plan
5. Redemption of Debentures
6. Accounting for Bonus and Rights Issue
7. Company: Introduction and Issue of Shares
8. Issue of Debentures
9. Amalgamation
10. Holding Company
11. Capital Reduction/Internal Reconstruction

This book has been designed keeping in mind the model syllabus of UGC, (i.e, CBCS) and is suitable for undergraduate and postgraduate students. Latest question papers from various universities have been solved for the benefit of the students.

Mr. S. Rangarajan bore us his hand in more ways than one in the production of the title. Much of the attractiveness and layout of this title is due to his untiring efforts.

A number of colleagues, friends and students helped us in the preparation of this book. We thank each and every one of them.

We are overwhelmed to receive invaluable suggestions and feedback from students, faculties and subject experts from different colleges and institutions across India. We have put our best to incorporate modifications wherever required and attempted to address most of the received inputs in this edition. We seek to receive many more suggestions and feedback in the future as well.

AUTHORS

Publisher's Note

We value your views, comments and suggestions and hence look forward to your communication at *info.india@mheducation.com.* Please feel free to report piracy issues, if any.

Preface to the First Edition

Accountancy is changing and, perhaps one might say, it is both green and flourishing. Many developments and modifications have taken place in this field of study because of the dynamic nature of business and the corollary changes in the textual treatment of books on accountancy.

In today's competitive world of real business, corporate accounting has assumed critical importance. Corporate accounting is not an end itself, but is intended to provide information that is vital in making business decisions.

We are indeed gratified by the reader response to Financial Accounting. Since its release in 2003, we have actively sought feedback from students, teachers and other professionals in the field. Corporate Accounting, almost two years in the making benefited from all the comments, suggestions and enthusiasm showered on Financial Accounting.

Essentially, we have retained all the winning ways of Financial Accounting. Each topic has been developed gradually and special care has been taken to ensure conceptual clarity. Topics of examination focus and those of particular relevance for students in their later-day professional careers have been given utmost importance. As in Financial Accounting, we have followed a pattern of theory, examples, illustrations (solved problems), theoretical questions, practice problems and guide to answers in each chapter.

Topics like Issue of Shares, Company Final Accounts, Amalgamation, Holding Company, Accounting Standards, Ratio Analysis, Fund Flow Statement, Cash Flow Statement, have been dealt with elaborately.

From our teaching experience, we found that it is extremely important to reinforce the theoretical principles with actual practice. For this purpose, we have included about 630 fully solved problems interspersed within the text. In addition, nearly 340 unsolved problems (with guide to answers) have been graded with different levels of difficulty. Almost all the problems presented in this book have been taken from different university and professional examinations.

Mr. S. Rangarajan bore us his hand in more ways than one in the production of the title. Much of the attractiveness and layout of this title is due to his untiring efforts.

A number of colleagues and friends helped us in the preparation of this book. We thank each and every one of them.

There is never any finality or perfection in human creation. We trust that there is always scope for innovation and, as such, of improvement. Suggestions for further improvements would be more than welcome from fellow teachers and students.

AUTHORS

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Company : Introduction and Issue of Shares

Introduction

There are several forms of business organisations. ***Examples*** are : sole proprietorship, partnership, company, etc. For management and protection of interest of the partners, there is Partnership Act, 1932. However, for management of sole proprietorship business there is no specific Act. For management of company, there is Companies Act. It is important to note that other than company, no form of business organisations have 'legal entity' separate from its owner / partners / members.

A company is a legal entity separate from its shareholders / members. It is an association of persons for a business purpose or other purposes*. Its capital is subscribed by the shareholders and it operates as one single unit in the success of which all the members participate.

Definition of a Company

As per the provision of Section 2(20) of the Companies Act, 2013 'company' means a company incorporated under this Act or under any previous company law. It is worth mentioning that there were number of Companies Acts / Laws before the enactment of the Companies Act, 2013 such as :

(i) The Companies Act, 1956
(ii) The Companies Act, 1913
(iii) The Companies Act, 1882
(iv) The Companies Act, 1866

It is to be noted that the above definition of company is not comprehensive. To understand the meaning of company, the following definitions given by different authors are very important. Some of the definitions are given below :

Prof. Haney defines a company as "the company is an artificial person created by law, having separate entity, with a perpetual succession and common seal."

Lord Justice Lindley defines a Company as follows :

"By a Company is meant an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the Company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share".

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* The Companies Act, 2013 allows to form a company for non-economic purposes also, *e.g.*, promoting commerce, arts, science, sports, religion or charity, etc.

Characteristics of a Company

The following are the main characteristics of a Company :

1. A Company comes into existence only after incorporation under the Companies Act.
2. A Company is a legal entity separate and distinct from its members. It can enter into a contract. It can sue and be sued in its own name.
3. A shareholder of a company, in its individual capacity, cannot bind the Company in any way.
4. The equity capital of a Company is typically subscribed by shareholders who receive return in the form of dividend.
5. The shareholder of a Company can transfer its share and ordinarily the transferee becomes a member of the Company.
6. The liabilities of shareholder of a Company are usually limited.
7. A Company is managed by the Board of Directors, whole time Directors, Managing Director or Manager. These persons are selected according to the provision of the Companies Act and Articles of Association of the Company.
8. The Company has perpetual succession. The insolvency or death of a shareholder will not affect its existence.
9. A Company must have a registered office.
10. A Company must have a common seal.

Types of Companies

The Companies Act, 2013 allows to form a company for economic as well as non-economic purposes. A company may be either :

(i) a company limited by shares; or
(ii) a company limited by guarantee; or
(iii) an unlimited company

The most common types of companies are :

1. Private Companies; and
2. Public Companies

Private Companies

As per the provision of Section 2(68) of the Companies Act, 2013 'private company' means a company having a minimum paid-up share capital of one lakh rupees or such higher paid-up capital as may be prescribed and which by its articles —

(i) restricts the right to transfer its share;
(ii) except in case of one person company, limits the number of its members to two hundred;
(iii) prohibits any invitation to the public to subscribe for any securities of the company.

Private companies can be re-classified as :

(i) One Person Company (OPC)
(ii) Small Companies

One Person Company (OPC)

The concept of one person company has been introduced for the first time in the Companies Act, 2013. As per the provision of Section 2(62) of the Companies Act, 2013 '***one person company' means a company which has only one person as member***'.

Characteristics of One Person Company

1. It is a one member company.
2. It is a private company.
3. It may be registered as 'limited by shares' or 'limited by guarantee'.
4. The phrase 'one person company' shall be mentioned within a bracket below the name of the company.
5. In the memorandum, it should indicate the name of the 'other person; who shall become member of the company in case of death or incapability of the promoter. Prior written consent in the prescribed form should be taken from such person.
6. It may not have to prepare 'Cash Flow Statement' as part of Financial Statements.

7. There is no need of holding Annual General Meeting.
8. The Financial Statements can be submitted within 6 months from the date of closing of the books of accounts.

Small Company

The concept of small company has been introduced in the Companies Act, 2013. As per the provision of Section 2(85) 'small company' means a company other than a public company—

(i) paid-up share capital of which does not exceed ***fifty lakh rupees*** or such higher amount as may be prescribed which shall not be more than ***five crore rupees***; or

(ii) turnover of which as per last Profit and Loss Account does not exceed two crore rupees, or such higher amount as may be prescribed which shall not be more than twenty crore rupees.

However, this clause ***shall not*** apply to

(a) a holding or a subsidiary company;

(b) a company registered under Section 8 (Non-profit association for charitable purposes);

(c) a company or body corporate governed by any special Act.

Public Company

As per the provision of Section 2(71) of the Companies Act, 2013 'public company' means a company which—

(a) is not a private company;

(ii) has a minimum paid-up share capital of ***five lakh rupees*** or such higher paid-up capital as may be prescribed.

However, a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles.

Distinction between a Public Company and a Private Company

Sl. No.	**Basis of Distinction**	**Public Company**	**Private company**
1.	Formation	Minimum 7 persons are required to form a public company.	Minimum 2 persons are required to form a private company. However, 'one person company' can be formed as per the provision of Section 3 of the Companies Act, 2013 with a single person.
2.	Maximum Number of Members	In a public company there may be any number of members.	In a private company (except one person company) maximum number of members cannot exceed 200.
3.	Restriction on Transfer of Shares	In a public company the shares are freely transferrable.	In a private company the right to transfer shares is restricted by the Articles of Association.
4.	Number of Directors	A public company must have at least 3 directors.	A private company must have least 2 directors.
5.	Independent Director	In case of a ***listed*** public company at least $^1/_3$rd should be independent directors.	Question of independent director does not arise.
6.	Invitation to Public	There is no restriction for a public company to invite the public to purchase its shares or debentures or bonds.	A private company cannot invite the public to purchase its shares or debentures.

7.	Prospectus	A public company must file a prospectus or a statement in lieu of prospectus before public issue.	A private company need not file a prospectus or a statement in lieu of prospectus.
8.	Small Company	In case of a public company there is no concept of 'small company'.	In case of a private company there is a concept of 'small company'. A private company will be treated as a small company when its paid-up capital does not exceed fifty lakh rupees and turnover does not exceed two crore rupees.
9.	Minimum Paid-up Capital	In case of a public company minimum paid-up capital is five lakh rupees.	In case of a private company minimum capital is one lakh rupees.
10.	Special Privilege	A public company enjoys no special privileges.	A private company enjoys some special privileges.
11.	Retirement of Directors	The directors of a public company retires by rotation.	All directors of a private company can be non-rotational directors.
12.	Managerial Remuneration	In case of a public company the managerial remuneration is restricted to 11% of the net profit of the company.	In case of a private company there is no restriction on managerial remuneration.
13.	Acceptance of Public Deposits	Subject to the provision of Section 76, a public company can accept deposits from public.	A private company cannot accept deposits from the public.
14.	Name	The word 'Limited' is used with the name of the company. ***For example***, 'Reliance Industries Limited', 'Tata Motors Limited', etc.	The phrase 'Private Limited' is used with the name of the company. ***For example***, 'McGraw Hill Education (India) Private Limited'.

Sources of Capital of a Company — Shares

A joint stock company (private or public) raises its capital by issuing shares. A private limited company, however, issues shares informally, by personal contact between the directors and investors. It cannot invite the public to buy its shares. On the contrary a public limited company is free to invite the public to buy its shares. It issues a prospectus and takes the help of underwriters in order to sell its shares.

Shares

According to Section 2(84) of the Companies Act, 2013, a share represents a 'unit' into which the capital of a company is divided. ***For example***, the share capital of a company is ₹ 6,00,000. It is divided into 1,20,000 units of ₹ 5 each. Each 'unit of ₹ 5' will be called a ***share of the company***.

Each share in a company is distinguished by its appropriate number. Shares are classified as movable property, transferable in the manner specified by the Articles. A certificate under the common seal of the company is issued to the shareholders to provide them with prima facie evidence of their title to the shares specified therein and is known as a ***Share Certificate***.

The Nature and Kinds of Shares

Every company is financed mainly by the issue of shares. To suit the taste and temperament of different types of investors, company issue different kinds of shares. Section 93 of the Companies Act, 2013 provides that the share capital of a company limited by shares shall be of ***two*** kinds, namely,

(a) Equity Share Capital —
  (i) with voting rights; or
  (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.
(b) Preference Share Capital

Equity Share / Equity Share Capital

Equity Share Capital means all share capital which is not 'preference share' capital (to be explained shortly). The holder of an equity share with ***voting rights*** is entitled to vote, proportionately, in general meeting of the company. This gives the equity shareholder the power to appoint directors of the company. The equity shareholders are also entitled to a share of the company's annual profit in the form of dividend. The rate of dividend may vary from year to year depending upon the profit and dividend policy of the company. However, the equity shareholders run two risks. ***First,*** when the company fails to earn profit, the equity shareholders may not get any dividend at all. ***Second,*** when the company is liquidated, the equity shareholders get back their capital at last after satisfying creditors, lenders and preference shareholders.

Normally, the company does not repay its equity shareholders before liquidation. Some companies may buy-back some of the equity shares. If a equity shareholder wants to sell his share, he will have to find out the buyer (applicable to unlisted / private companies). However, equity shareholder of a ***listed*** company can sell its share easily at any stock exchange.

It is to be noted here that the Companies Act, 2013 allows the issue of equity shares without voting rights. However, these shares are to be issued as per Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014. These rules have been discussed in page 1.15 of this Chapter.

Features of an Equity Share

(1) It is a part of the capital of the company.
(2) It can be purchased or sold in a stock exchange in case of listed company.
(3) It has no cumulative rights to dividends.
(4) It can vote in the election of directors.
(5) It can take part in the making of certain important company decisions.
(6) It can participate in the profits of the company.
(7) It can purchase a proportionate part of future share issues (i.e., rights issue).
(8) It has the right to share in assets upon liquidation.

Preference Share Capital / Preference Shares

Preference Share Capital means that part of the issued share capital of the company which carries or would carry a preferential right with respect to—

(a) payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and
(b) repayment, in the case of a winding-up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

Unlike equity shares, preference shares carry no voting rights. The preference shareholders are entitled to a fixed rate or fixed amount of dividend.

For example, 10% Preference Shares of ₹ 100 each means that the preference shareholder will get ₹ 10 per share as dividend. According to the situation and market conditions, a company may issue preference shares at different rate of dividend at different points of time.

Features of a Preference Share

(1) It has preferential rights to dividends at a fixed rate or fixed amount as the case may be.
(2) It has cumulative rights to dividends.

(3) It has preferential rights to assets of the company in the case of liquidation.
(4) It is redeemable before the expiry of a period of ***twenty*** years from the date of its issue.
(5) It can be purchased or sold in a stock exchange at a price above or below its face value.
(6) It has no voting power in general.
(7) It may or may not be converted into equity share(s).

Advantages

From the Company's Point of View

1. Since the rate of dividend / amount of dividend is fixed, the company knows in advance the amount of dividend to be paid to the preference shareholders.
2. It is one of the permanent source of long-term capital which does not have to be repaid immediately (not before 20 years; in many cases it is to be repaid within 30 years). ***For example***, a company engaged in the setting up and dealing with infrastructural projects may issue preference shares which will be redeemed within 30 years.

From the Shareholders' Point of View :

1. The rate / amount of dividend is fixed. It is an assured income not depending upon the amount of profit made by the company.
2. No tax is to be paid by the shareholders on dividend received.It is paid by the company.

Disadvantages

From the Company's Point of View :

1. Dividend is not allowable as deduction for calculating taxable income. It is relevant to mention here that interest on debentures or long-term debts are allowable as deduction for calculation of taxable income.
2. The company is liable to pay corporate dividend tax on the dividend paid.

Tutorial Note : Because of the above reasons, it is very unpopular to issue preference shares. Now-a-days, majority of the companies prefer to take long-term loans from bank or other financial institutions.

From Shareholders' Point of View :

1. They can not take part in the election of directors.
2. When the company is earning good profits and paying equity dividend at a higher rate, the preference shareholders only get a fixed percentage of dividend which is very low in many cases.
3. True return on investment is low when the inflation is high.

Sub-division of Preference Shares

Preference Shares can be sub-divided into different classes, such as :

(a) Cumulative and non-cumulative preference shares;
(b) Participating and non-participating preference shares; and
(c) Redeemable and non-redeemable preference shares.

(i) Cumulative and Non-cumulative Preference Shares

A fixed rate / amount of dividend is paid to preference shareholders before payment of dividend paid to the equity shareholders. It may so happen that the company's current year profit is not enough or the company has incurred losses and it cannot pay the dividend to the preference shareholders. In the case of cumulative preference shares, the deficiency accumulates and it is to be paid out of the profits of the subsequent years.

In case of non-cumulative preference shares, dividend is only payable out of net profit of each year and shares do not have the privilege of accumulation of the unpaid dividends. It should be noted that if nothing is specified in the Articles, it will be treated as ***cumulative preference shares***.

(ii) Participating and Non-participating Preference Shares

Participating preference shares are those preference shares which are entitled to a fixed rate of preferencial dividend and in addition, enjoy a right to participate in the surplus profits (along with equity shareholders) after paying dividend to equity shareholders at a certain rate. Further, in the event of winding up, if there is any surplus left after paying preference shareholders and equity shareholders, then participating preference shareholders are entitled to get a portion of the surplus of assets of the company.

If the articles or the terms of issue of preference shares do not specifically allow participation in surplus, then preference shareholders get only the fixed preferencial dividend and return of capital at the time of winding up of the company, after meeting external liabilities and these preference shares are called non-participating preference shares.

(iii) Redeemable and Non-redeemable Preference Shares

Redeemable preference shares are those which are redeemed by the company after certain years (as per the terms and conditions of the issue). Irredeemable preference shares are those which cannot be redeemed before liquidation.

In this respect, the provision of ***Section 55 of the Companies Act, 2013*** is very important. which states that:

(1) No company limited by shares shall, after the commencement of this Act, issue any preference shares which are irredeemable.

(2) A company limited by shares may, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding ***twenty years*** from the date of their issue subject to such conditions as may be prescribed.

Distinction Between Equity Share and Preference Share

	Equity Share		Preference Share
1.	It is the risk capital of a company.	1.	It is not the risk capital of a company.
2.	A company must have equity shares.	2.	A company may not have any preference share.
3.	It has higher expected rate of dividend than preference shares.	3.	It has the right to get dividend at a fixed rate / fixed amount.
4.	It has no preferential right to dividend.	4.	It has preferential rights to dividends.
5.	It has no cumulative right to dividend.	5.	It has cumulative right to dividend.
6.	It has voting power.	6.	It has no voting power.
7.	Equity shareholders can take part in the meeting of certain important company decisions.	7.	Preference shareholders have no such right.
8.	It is not redeemable.	8.	It is redeemable before the expiry of twenty years from the date of issue.
9.	It cannot be converted into preference shares.	9.	It may be converted into equity shares.
10.	At the time of liquidation, equity shareholders are paid off last.	10.	At the time of liquidation, preference share-holders are paid off before the equity share-holders.
11.	Equity shareholders can purchase a proportion-ate part of future share issues i.e. rights share.	11.	Preference shareholders have no such right.

Stock

As per the provision of Section 62(1)(c) of the Companies Act, 2013 a limited company having a share capital may, if so authorised by its articles, convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination. ***Stock is the aggregate of fully paid-up shares legally consolidated and portion of which aggregate may be transferred or split up into fractions of any amount without regard to the original nominal amount of shares***.

Distinction between Shares and Stock

(1) Shares are in units but stock is in lump holding.
(2) Shares can be issued directly but stock cannot be issued directly.
(3) Shares need not be fully paid but stock must be fully paid.
(4) Shares must be numbered but stock is never numbered.
(5) Shares cannot be transferred in fractional amount but stock can be transferred in fractional amount.

Sub-division of Share Capital of a Company

(i) Authorised Capital or Nominal Capital

It means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company. [***Section 2(8)***]

(ii) Issued Capital

It means such capital as the company issues from time to time for subscription [***Section 2(50)***].

(iii) Subscribed Capital

It means such part of the capital which is for the time being subscribed by the members of a company (***Section 2(86)***].

(iv) Paid-up Share Capital or Share Capital Paid-up

It means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called [***Section 2(64)***].

(v) Uncalled Capital

It is that part of the subscribed capital which has not been called-up by the Board of Directors.

(vi) Reserve Capital

A limited company may, by special resolution, determine that any portion of its share capital which has not been already called-up shall not be capable of being called-up, except in the event and for the purposes of the company being wound up. This uncalled portion of the share capital is called ***Reserve Capital***.

Disclosure of Share Capital in the Company's Balance Sheet

The disclosures in respect of Share Capital are to be made in the '***Notes to Accounts***'. The following aspects are to be disclosed for each class of share capital (different classes of preference shares are to be treated separately) :

(a) the number and amount of shares authorized;
(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
(c) par value per share;
(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
(g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;
(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
   - Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
   - Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
   - Aggregate number and class of shares bought back.

(j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers)
(l) forfeited shares (amount originally paid up)

Details of Share Capital of a Company are disclosed in the Notes to Accounts as follows :

Particulars	(₹)	(₹)
SHARE CAPITAL		
Authorised Capital :		
... Equity Shares of ₹ ... each	***	***
... Preference Shares of ₹ ... each	***	***
Issued Capital :		
... Equity Shares of ₹ ... each	***	***
... Preference Shares of ₹ ... each	***	***
Subscribed Capital :		
Subscribed and Fully Paid		
... Equity Shares of ₹ ... each	***	***
... Preference Shares of ₹ ... each	***	***
Subscribed but not Fully Paid		
... Equity Shares of ₹ ... each	***	***
... Preference Shares of ₹ ... each	***	***
	***	
Less: Calls-in-Arrear (if any)	***	
	***	
Add: Forfeited Shares (if any)	***	***
TOTAL		***

Explanation of Different Items of the Notes to Accounts Shown Above

(i) ***Authorised Capital*** :Authorised capital means the amount of share capital which a company is authorised to issue by its Memorandum of Association. It is also called 'Nominal Capital' or '***Registered Capital***'.

A company cannot issue more than the amount of capital specified in the Memorandum of Association. However, a company can increase its authorised capital after ***observing the procedures*** stated in the Companies Act.

(ii) ***Issued Capital*** : Issued capital is that part of the authorised capital which is issued for subscription to the public and other investors, including the shares allotted to promoters and vendors.

The difference between authorised capital and issued capital is called '***Unissued capital***'. The company can issue those shares in future.

Example : X Ltd. has been incorporated with authorised capital as follows :

10,00,000 equity shares of ₹ 10 each

1,00,000 preference shares of ₹ 50 each.

The company offered to the public 7,50,000 equity shares of ₹ 10 each.

The above matter is to be shown in the ***Notes to Accounts*** as follows :

Particulars	(₹)	(₹)
SHARE CAPITAL		
Authorised Capital :		
10,00,000 Equity Shares of ₹ 10 each	1,00,00,000	
1,00,000 Preference Shares of ₹ 50 each	50,00,000	1,50,00,000
Issued Capital :		
7,50,000 Equity Shares of ₹ 10 each		75,00,000

(iii) ***Subscribed Capital*** : Subscribed capital is that part of the issued capital which has been actually subscribed by the public and taken up by the promoters, other investors and vendors. As per 'Schedule III' subscribed capital is to be disclosed in the ***Notes to Accounts*** as follows :

(a) Subscribed and fully Paid; and

(b) Subscribed but not Fully Paid.

(a) ***Subscribed and Fully Paid*** : The shares which have been subscribed and fully called up and the entire amount has been received by the company will be shown under this heading.

For example, on 1st January, 2017 X Ltd. had issued 7,50,000 equity shares of ₹ 10 each. The issue was fully subscribed by the public. The entire amount was called up and it was received in full before 31st March, 2017.

On 31st March, 2017 it is to be shown in the Notes to Accounts as follows :

Subscribed Capital :

(a) *Subscribed and Fully Paid* :

7,50,000 Equity Shares of ₹ 10 each	₹ 75,00,000

(b) ***Subscribed but not Fully Paid*** : The shares which have been subscribed and fully called up but some of the shareholders could not pay the call money within the stipulated time. The amount not yet received will be treated as calls-in-arrear. In the ***Notes to Account***, the calls-in-arrear will be shown as a deduction from subscribed capital.

For example, on 1st January, 2017, X Ltd. had issued 7,50,000 equity shares of ₹ 10 each. The issue was fully subscribed and called up. Mr. Ramen, holding 5,000 equity shares could not pay the final call of ₹ 2 each by 25th March, 2017, the last date for payment of final call.

On 31st March, 2017, it is to be shown in the Notes to Accounts as follows :

Subscribed Capital :

(b) *Subscribed but not fully paid* :	₹
7,50,000 equity shares of ₹ 10 each	75,00,000
Less: Calls-in-arrear	10,000
	74,90,000

In this respect, it may be noted that when the company has not yet called up the entire amount of the face value of shares subscribed, the amount received will also be shown under 'Subscribed but not fully paid'.

For example, on 1st January, 2017, X Ltd. had issued 7,50,000 equity shares of ₹ 10 each. The issue was fully subscribed. Till 31st March, 2017, the company called up ₹ 8 per share. The entire amount was received in time.

On 31st March, 2017 it is to be shown in the ***Notes to Accounts*** as follows :

Subscribed Capital :

(b) Subscribed but not fully paid

7,50,000 equity shares of ₹ 10 each, ₹ 8 paid up	₹ 60,00,000

Illustration 1

The authorised capital of XYZ Ltd. is ₹ 20,00,000 divided into 2,00,000 equity shares of ₹ 10 each. Out of these, company issued 1,00,000 equity shares of ₹ 10 each. The amount is payable as follows:

On application ₹ 2; On allotment ₹ 5; and On final call ₹ 3.

The public applied for 90,000 equity shares and all the money was duly received.

You are required to :

(a) Show Share Capital in the Balance Sheet of the company as at 31st March, 2017; and

(b) Prepare Notes to Accounts for the same.

Solution

XYZ Ltd.
Balance Sheet as at 31st March, 2017

EQUITY AND LIABILITIES	Notes	31.3.2017 ₹	31.3.2016 ₹
1. Shareholders' Funds			
(a) Share Capital	(1)	9,00,000	?
Total		9,00,000	?

Notes to Accounts :

(1) Share Capital

Particulars	31.3.2017 ₹
Authorised Capital :	
2,00,000 Equity Shares of ₹ 10 each	20,00,000
Issued Capital :	
1,00,000 Equity Shares of ₹ 10 each	10,00,000

Subscribed Capital : (1) *Subscribed and fully paid* 90,000 Equity Shares of ₹ 10 each	9,00,000

Illustration 2

On 1st April, 2016 Ashok Ltd. was formed with an authorised capital of ₹ 1,00,00,000 divided into 2,00,000 equity shares of ₹ 50 each. The company issued prospectus inviting applications for 1,50,000 shares. The issue price was payable as under :

On application ₹ 15; On allotment ₹ 20; and On call Balance.

The issue was fully subscribed and the company allotted shares to all the applicants.

The company did not make the call during the year.

The company also issued 5,000 shares of ₹ 50 each fully paid-up to the vendor for purchase of office premises.

Show the

(a) Share Capital in the Balance Sheet of the Company as per Schedule III of the Companies Act, 2013.

(b) Also prepare 'Notes to Accounts'.

Solution

Ashok Ltd.
Balance Sheet as at 31st March, 2017

EQUITY AND LIABILITIES	Notes	31.3.2017 ₹ '000	31.3.2016 ₹
1. Shareholders' Funds			
(a) Share Capital	(1)	5,500	***
Total		5,500	***

Notes to Accounts :

(1) Share Capital

Particulars	31.3.2017 (₹ '000)
Authorised Capital :	
2,00,000 Equity Shares of ₹ 50 each	10,00,000
Issued Capital :	
1,50,000 Equity Shares of ₹ 50 each issued to public	7,500
5,000 Equity Shares of ₹ 50 each issued to vendor	250
	7,750
Subscribed Capital :	
(i) *Subscribed and fully paid*	
5,000 Equity Shares of ₹ 50 each(issued to vendor for consideration other than cash)	250
(ii) *Subscribed but not fully paid*	
1,50,000 Equity Shares of ₹ 50 each issued to public, ₹ 35 each called up and paid-up	5,250
Total	5,500

Points to be Noted

(1) Calls unpaid are required to be disclosed, stating separately the aggregate value of calls unpaid by directors and officers of the Company.

(2) The amount of 'Calls paid in advance' does not form part of the paid-up capital. Under Schedule III, calls in advance should be disclosed under 'other current liabilities'. The amount of interest, if any, on such advance should also be shown under 'other current liabilities.

Notes to Accounts related to Share Capital has been shown below taking from the Annual Report of Reliance Industries Ltd. for the year 2015-6. It will help the students to understand the above discussed matter in respect of Share Capital.

Real Life Focus

Reliance Industries Ltd.
Notes on Financial Statements for the Year ended 31st March, 2016

The previous year figures have been regrouped / reclassified wherever necessary to conform to the current year presentation. **(₹ in crore)**

1. **SHARE CAPITAL**		**As at 31st March, 2016**		**As at 31st March, 2015**	
Authorised Share Capital :					
500,00,00,000 (500,00,00,000)	**Equity Shares of ₹ 10 each**		**5,000**		**5,000**
100,00,00,000 (100,00,00,000)	**Preference Shares of ₹ 10 each**		**1,000**		**1,000**
			6,000		**6,000**
Issued, Subscribed and Paid up :					
3,24,03,76,321 (3,23,56,88,765)	**Equity Shares of ₹ 10 each fully paid up**	**3,240**		**3,236**	
	Less : Calls in arrears - by others [₹ 2,303 (Previous year ₹ 3,113)]	**–**	**3,240**	**–**	**3,236**
TOTAL			**3,232**		**3,229**

Illustration 3

The authorised capital of Suhas Ltd. is ₹ 50,00,000 divided into 25,000 shares of ₹ 200 each. Out of these the company issued 12,000 shares of ₹ 200 each at a premium of 10%. The amount was payable as follows :

₹ 60 per share on application; ₹ 60 per share on allotment (including premium), ₹ 30 per share on first call and balance on final call. Public applied for 11,000 shares. All the money was duly received.

Prepare an extract of Balance Sheet of Suhas Ltd. as per Schedule III Part I of the Companies Act, 2013 disclosing the above information. Also prepare notes to accounts for the same.

Solution

Suhas Ltd
Balance Sheet as at .... [Extract] **(Figures in ₹)**

Particulars	Note No.	Figures as at the end of current reporting period
1	2	3
I. EQUITY AND LIABILITIES		
(1) **Shareholders' Funds**		
(a) Share capital	(1)	22,00,000
(b) Reserves and surplus	(2)	2,20,000
(c) Money received against share warrants		—
TOTAL		24,20,000
II. ASSETS		
(2) **Current Assets**		
(d) Cash and cash equivalents	(3)	24,20,000
TOTAL		24,20,000

Notes to Accounts :

(1) Share Capital	₹	₹
Authorised Capital :		
25,000 Equity Shares of ₹ 200 each		50,00,000
Issued Capital :		
12,000 Equity Shares of ₹ 200 each		24,00,000
Subscribed Capital :		
Subscribed and Fully Paid: 11,000 Equity Shares of ₹ 200 each		22,00,000
(2) Reserve and Surplus		
Securities Premium Reserve		
11,000 Shares @ ₹ 20 each		2,20,000
(3) Cash and Cash Equivalents		
Cash at bank		24,20,000

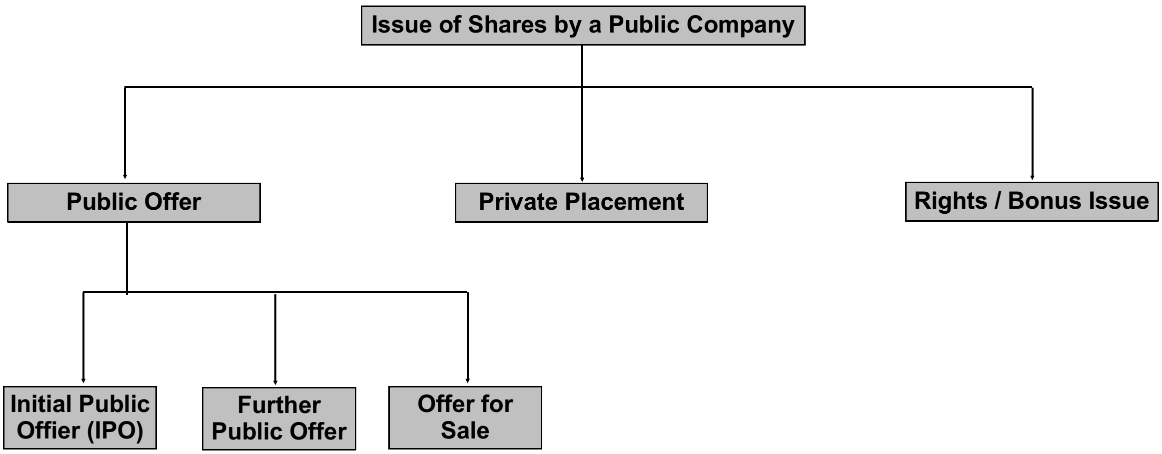
The Issue of Shares

As per the provision of Section 23(1) of the Companies Act, 2013 a ***public company*** may issue securities :

(a) to public through prospectus (herein referred to as "public offer"). Public offer includes initial public offer, further public offer and offer for sale.

(b) through private placement;

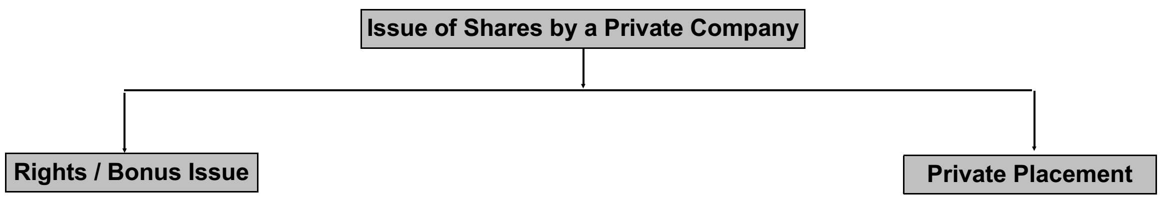
(c) through a rights issue or a bonus issue.



As per the provision of Section 23(2) of the Companies Act, 2013, a ***privtae company*** may issue securities—

(a) by way of rights issue or bonus issue

(b) through private placement



Public Offer / Public Issue of Shares

Public issue of shares means selling of shares to the public by issue of a prospectus. A number of methods may be used to issue shares to the public, e.g., IPO, FPO and offer for sale. Issue of shares to the public are complex matters. The Government rules and regulations are very strict since the money is collected from the public. Therefore, great care should be taken before an offer is made to the public by the company.

Initial Public Offer (IPO)

Initial public offer means an offer of specified securities by an ***unlisted*** issuer to the public for subscription and includes an 'offer of sale' of specified securities to the public by an existing holder of such securities in an unlisted issuer.

It is to be noted that public offer is governed by the SEBI (Issue of Capital and Disclosure Requirements) Regulation, 2009. Some of the important regulations are given below :

No issuer shall make a public issue or rights issue of specified securities :

(a) if the issuer, any of its promoters, promoter group or directors or persons in control of the issuer are ***debarred*** from accessing the capital market by the Board;

(b) if any of the promoters, directors or persons in control of the issuer was or also is a promoter, director or person in control of any other company which is ***debarred*** from accessing the capital market under any order or directions made by the Board;

(c) if the issuer of convertible debt instruments is in the list of ***wilful defaulters*** published by the Reserve Bank of India or it is in default of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any, for a period of more than six months;

(d) unless it has made an application to one or more recognised stock exchanges for listing of specified securities on such stock exchanges and has chosen one of them as the designated stock exchange:
Provided that in case of an initial public offer, the issuer shall make an application for listing of the specified securities in at least one recognised stock exchange having nationwide trading terminals;

(e) unless it has entered into an agreement with a ***depository*** for dematerialisation of specified securities already issued or proposed to be issued;

(f) unless all existing ***partly paid-up equity shares*** of the issuer have either been fully paid up or forfeited;

(g) unless firm arrangements of finance through verifiable means towards seventy five per cent. of the stated means of finance, excluding the amount to be raised through the proposed public issue or rights issue or through existing identifiable internal accruals, have been made.

Eligibility Requirements for IPO

Regulation 26 of SEBI (ICDR) Regulations, 2009 states that :

(1) An issuer may make an initial public offer if :

(a) it has net tangible assets of at least ***three*** crore rupees in each of the preceding three full years (of twelve months each), of which not more than fifty per cent. are held in monetary assets:
Provided that if more than fifty per cent. of the net tangible assets are held in monetary assets, the issuer has made firm commitments to utilise such excess ***monetary assets**** in its business or project;
[Provided further that the limit of fifty per cent. on monetary assets shall ***not be applicable*** in case the public offer is made entirely through ***an offer for sale***.]

(b) it has a minimum average pre-tax operating profit of rupees fifteen crore, calculated on a restated and consolidated basis, during the three ***most profitable*** years out of the immediately preceding five years.

(c) it has a net worth of at least one crore rupees in each of the preceding three full years (of twelve months each);

(d) the aggregate of the proposed issue and all previous issues made in the same financial year in terms of issue size does not exceed ***five times*** its pre-issue net worth as per the audited balance sheet of the preceding financial year;

(e) if it has ***changed its name*** within the last one year, at least fifty per cent. of the revenue for the preceding one full year has been earned by it from the activity indicated by the new name.

(2) An issuer not satisfying the condition stipulated in sub-regulation (1) may make an initial public offer if the issue is made through the ***book-building*** process and the issuer undertakes to allot, at least seventy five percent of the net offer to public, to ***qualified institutional buyers*** and to refund full subscription money if it fails to make the said minimum allotment to qualified institutional buyers.

(3) An issuer may make an initial public offer of convertible debt instruments without making a prior public issue of its equity shares and listing thereof.

(4) An issuer shall not make an allotment pursuant to a public issue if the number of prospective allottees is less than ***one thousand***.

(5) No issuer shall make an initial public offer if there are any outstanding convertible securities or any other right which would entitle any person with any option to receive equity shares:
Provided that the provisions of this sub-regulation shall not apply to:

(a) a public issue made during the currency of convertible debt instruments which were issued through an earlier initial public offer, if the conversion price of such convertible debt instruments

* A monetary asset is an asset whose value is a fixed stated amount. ***Example***s are cash, accounts receivables, etc.

was determined and disclosed in the prospectus of the earlier issue of convertible debt instruments;

(b) outstanding options granted to employees pursuant to an employee stock option scheme framed in accordance with the relevant Guidance Note or Accounting Standards, if any, issued by the Institute of Chartered Accountants of India in this regard.

(c) fully paid-up outstanding convertible securities which are required to be converted on or before the date of filing of the red herring prospectus (in case of book-built issues) or the prospectus (in case of fixed price issues), as the case may be.

(6) Subject to provisions of the Companies Act and these regulations, equity shares may be offered for sale to public if such equity shares have been held by the sellers for a period of at least one year prior to the filing of draft offer document with the Board in accordance with subregulation (1) of regulation 6:

Provided that in case equity shares received on conversion or exchange of fully paid-up compulsorily convertible securities including depository receipts are being offered for sale, the holding period of such convertible securities as well as that of resultant equity shares together shall be considered for the purpose of calculation of one year period referred in this sub-regulation:

Provided further that the requirement of holding equity shares for a period of one year shall not apply:

(a) in case of an offer for sale of specified securities of a government company or statutory authority or corporation or any special purpose vehicle set up and controlled by any one or more of them, which is engaged in infrastructure sector;

(b) if the specified securities offered for sale were acquired pursuant to any scheme approved by a High Court under sections 391-394 of the Companies Act, 1956, in lieu of business and invested capital which had been in existence for a period of more than one year prior to such approval;

(c) if the specified securities offered for sale were issued under a bonus issue on securities held for a period of at least one year prior to the filing of draft offer document with the Board and further subject to the following, -

(i) such specified securities being issued out of free reserves and share premium existing in the books of account as at the end of the financial year preceding the financial year in which the draft offer document is filed with the Board ; and

(ii) such specified securities not being issued by utilization of revaluation reserves or unrealized profits of the issuer.

(7) An issuer making an initial public offer may obtain grading for such offer from one or more credit rating agencies registered with the Board.

Further Public Offer (FPO)

Further public offer means an offer of specified securities by a ***listed issuer*** to the public for subscription and includes an offer for sale of specified securities to the public by an existing holder of such securities in a listed issuer. ***Regulation 27*** of SEBI (ICDR) Regulations, 2009 states that:

An 'issuer' may make a further public offer (FPO) if it satisfies the following conditions :

(1) the aggregate of the proposed issue and all previous issues made in the same financial year in terms of issue size does not exceed 5 times of its pre-issue ***net worth*** as per the audited Balance Sheet of the preceding financial year;

(2) if it has changed its name within ***last one year***, at least 50% of the revenue for the preceding one full year has been earned by it from the activity indicated by the new name.

If the company does not satisfy the above conditions, it may make further public offer through book building process and the issuer undertakes to allot, at least 75% of the net offer to the public, to ***qualified institutional buyers*** and to refund full subscription money if it fails to make the said minimum allotment to qualified institution buyers.

The meaning of '***Qualified Institutional Buyers***', '***Net Offer to Public***' and '***Net worth***' are given below :

(a) "***Qualified institutional buyer***" means :
   (i) a mutual fund, venture capital fund [Alternative Investment Fund] and foreign venture capital investor registered with the Board;
   (ii) a foreign portfolio investor other than Category III foreign portfolio investor], registered with the Board;
   (iii) a public financial institution;
   (iv) a scheduled commercial bank;
   (v) a multilateral and bilateral development financial institution;
   (vi) a state industrial development corporation;
   (vii) an insurance company registered with the Insurance Regulatory and Development Authority;
   (viii) a provident fund with minimum corpus of twenty five crore rupees;
   (ix) a pension fund with minimum corpus of twenty five crore rupees;
   (x) National Investment Fund set up by the Government of India;
   (xi) insurance funds set up and managed by army, navy or air force of the Union of India;
   (xii) insurance funds set up and managed by the Department of Posts, India;

(b) "***Net offer to public***" means an offer of specified securities to the public but does not include reservations;

(c) "***Net worth***" means the aggregate of the paid up share capital, securities premium account, and reserves and surplus (excluding revaluation reserve) as reduced by the aggregate of miscellaneous expenditure (to the extent not adjusted or written off) and the debit balance of the profit and loss account;

Private Placement

As per the provision of ***Section 23 of Companies Act, 2013***, both ***public*** company and ***private*** company can issue shares through private placement. Private placement means any offer of securities or invitation to subscribe securities to a select group of persons by a company through issue of a private placement ***offer letter***.

Section 42 of the Companies Act, 2013 has specified certain conditions for 'private placement' of shares. Some of the important conditions are given below :

(1) The offer of securities or invitation to subscribe securities, shall be made to such number of persons ***not exceeding fifty*** or such higher number as may be prescribed, excluding qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option.

(2) No fresh offer or invitation under this section shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.

(3) Any offer or invitation not in compliance with the provisions of this section shall be ***treated as a public offer*** and all provisions of this Act, and the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be required to be complied with.

(4) All monies payable towards subscription of securities under this section shall be paid through cheque or demand draft or other banking channels but not by cash.

(5) A company making an offer or invitation under this section shall allot its securities within ***sixty days*** from the date of receipt of the application money for such securities and if the company is not able to allot the securities within that period, it shall repay the application money to the subscribers within ***fifteen days from the date of completion of sixty days*** and if the company fails to repay the application money within the aforesaid period, it shall be liable to repay that money with interest at the rate of twelve per cent. per annum from the expiry of the sixtieth day:
Provided that monies received on application under this section shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than—
(a) for adjustment against allotment of securities; or
(b) for the repayment of monies where the company is unable to allot securities.

(6) All offers covered under this section shall be made only to such persons whose names are recorded by the company prior to the invitation to subscribe, and that such persons shall receive the offer by name, and that a complete record of such offers shall be kept by the company in such manner as may be prescribed and complete information about such offer shall be filed with the Registrar within a period of ***thirty days*** of circulation of relevant private placement offer letter.

(7) No company offering securities under this section shall release any public advertisements or utilise any media, marketing or distribution channels or agents to inform the public at large about such an offer.

(8) Whenever a company makes any allotment of securities under this section, it shall file with the Registrar ***a return of allotment*** in such manner as may be prescribed, including the complete list of all security-holders, with their full names, addresses, number of securities allotted and such other relevant information as may be prescribed.

(9) If a company makes an offer or accepts monies in contravention of this section, the company, its promoters and directors shall be liable for a penalty which may extend to the amount involved in the offer or invitation or ***two crore rupees***, whichever is higher, and the company shall also refund all monies to subscribers within a period of ***thirty days*** of the order imposing the penalty.

Equity Shares with Differential Rights

Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014, provides that :

(1) No company limited by shares shall issue equity shares with differential rights as to dividend, voting or otherwise, unless it complies with the following conditions, namely:-

- (a) the articles of association of the company authorizes the issue of shares with differential rights;
- (b) the issue of shares is authorized by an ***ordinary resolution*** passed at a general meeting of the shareholders:

  Provided that where the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot ;
- (c) the shares with differential rights shall not exceed ***twenty-six percent*** of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time;
- (d) the company having consistent track record of distributable profits for the last three years;
- (e) the company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares;
- (f) the company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend;
- (g) the company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government;
- (h) the company has not been penalized by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934 , the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.

(2) The company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and vice–versa.

Face Value of Equity Shares

An issuer making an initial public offer may determine the face value of the equity shares in the following manner :

(a) if the issue price per equity share is ₹ 500 or more, the issuer shall have the option to determine the face at less than ₹ 10 per equity share. However, the face value shall not be less than one rupee per equity share.

(b) if the issue price per equity share is less than ₹ 500, the face value of the equity shares shall be ₹ 10 per equity share.

The disclosure about the face value of equity shares (including statement about issue price being 'X' times of the face value) shall be made in the advertisements, offer documents and application forms in identical front size as that of issue price or price band.

For example, the issue price is ₹ 400. The face value is ₹ 10. It should be stated in the advertisements, offer documents and application form that the issue is 40 times of the face value..

Pricing in Public Issue

Pricing

(1) An issuer may determine the price of specified securities in consultation with the lead merchant banker or through the book building process.

(2) An issuer may determine the coupon rate and conversion price of convertible debt instruments in consultation with the lead merchant banker or through the book building process.

(3) The issuer shall undertake the book building process in a manner specified in Schedule XI [***See Appendix for details***].

Differential Pricing

An issuer may offer specified securities at different prices, subject to the following:

(a) retail individual investors or retail individual shareholders or employees entitled for reservation made under regulation 42 making an application for specified securities of value not more than two lakhs rupees, may be offered specified securities ***at a price lower than the price at which net offer is made*** to other categories of applicants:
Provided that such difference shall not be more than ten per cent. of the price at which specified securities are offered to other categories of applicants;

(b) in case of a book built issue, the price of the specified securities offered to an anchor investor shall not be lower than the price offered to other applicants;

(c) in case of a composite issue, the price of the specified securities offered in the public issue may be different from the price offered in rights issue and justification for such price difference shall be given in the offer document.

(d) in case the issuer opts for the alternate method of book building in terms of Part D of Schedule XI, the issuer may offer specified securities to its employees at a price lower than the floor price:
Provided that the difference between the floor price and the price at which specified securities are offered to employees shall not be more than ten per cent. of the floor price.

Basis for Issue Price

A key challenge in a public issue is to strike a fine balance between the needs of the company and investors. Merchant bankers conduct a market survey among institutional investors where a company's virtues are sold. The early feedback from institutional investors help the bankers get a feel of the market for the issue. When a management had a good reputation, it showed up in the form of a premium in the valuation. The following information shall be disclosed for all issues irrespective of the issue price :

(1) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital);

(2) P/E pre-issue

(3) Average return on net worth in the last three years

(4) Net Asset Value per share based on last balance sheet

(5) Comparison of all the accounting ratios of the issuer company with the industry average and with the accounting ratios of the peer group.
(6) All ratios should be calculated after taking into consideration the increase in capital because of compulsory conversion.

Minimum Application Size and Minimum Application Money in Public Issue

Minimum application value

(i) The minimum application value shall be within the range of ₹ 10,000 to ₹ 15,000. The issuer company, in consultation with merchant banker, shall stipulate the minimum application size (in terms of number of shares) falling within the aforesaid range of ***minimum application value*** and make upfront disclosures in this regard, in the offer document.
Explanation : For the purpose of this clause, the minimum application value shall be with reference to the issue price of the shares and not with reference to the amount payable on application.
Illustration : The issue price of shares is ₹ 500. Out of the same, ₹ 125 is payable on application and the balance on allotment and calls. In this instance, the application value of ₹ 10,000—₹ 15,000 shall be arrived at with reference to the issue price of ₹ 500. As such, the minimum application size, to be stipulated in the offer document, would range from 20 shares to 30 shares and not 80 shares to 120 shares.
(ii) The minimum sum payable on application shall not be less than 25% of the issue price. ***For example***, issue price is ₹ 500. The amount to be paid on application should not be less than ₹ 125 per share.
(iii) Applications can be made in multiples of the ***minimum size value*** so stipulated in the offer document by the issuer and merchant banker as at (i) and within the range of ₹ 10,000—₹ 15,000, as stipulated at in clause (i).

Schedule XIV

Illustration explaining the minimum application size

For inviting applications in multiples of the minimum value as referred above, the procedure is clarified by following example:

Assuming an issue is being made at a price of ₹ 900 per equity share. In this case, the issuer in consultation with the lead merchant banker can determine the minimum application lot within the range of 12 – 16 equity shares (in value terms between ₹ 10,000—₹ 15,000), as explained hereunder:

Options	I	II	III	IV	V
Lot size @ ₹ 900 per share	12 shares	13 shares	14 shares	15 shares	16 shares
Application / Bid amount for 1 lot (₹)	10,800	11,700	12,600	13,500	14,400
Application / Bid amount for 2 lots (₹)	21,600	23,400	25,200	27,000	28,800
Application / Bid amount for 4 lots (₹)	43,200	46,800	50,400	54,000	57,600
Application / Bid amount for 8 lots (₹)	86,400	93,600	1,00,800	1,08,000	1,15,200
Application / Bid amount for 16 lots (₹)	1,72,800	1,87,200	—	—	—
Application / Bid amount for 18 lots (₹)	1,94,400	—	—	—	—

The options given above are only illustrative and not exhaustive.

Allotment Procedure and Basis of Allotment

(1) The allotment of specified securities to applicants other than retail individual investors and anchor investors shall be on proportionate basis within the specified investor categories and the number of securities allotted shall be rounded off to the nearest integer, subject to minimum allotment being equal to the minimum application size as determined and disclosed by the issuer: Provided that value of specified securities allotted to any person shall not exceed two lakhs rupees.
(2) The allotment of specified securities to each retail individual investor shall not be less than the minimum bid lot, subject to availability of shares in retail individual investor category, and the remaining available shares, if any, shall be allotted on a proportionate basis.

(3) The executive director or managing director of the designated stock exchange along with the post issue lead merchant bankers and registrars to the issue shall ensure that the basis of allotment is finalised in a fair and proper manner in accordance with the allotment procedure as specified in Schedule XV.

Illustration Explaining Procedure of Allotment

(1) Total number of specified securities on offer @ ₹ 600 per share: 1 crore specified securities.
(2) Specified securities on offer for retail individual investors' category: 35 lakh specified securities.
(3) The issue is over-subscribed 2.5 times whereas the retail individual investors' category is oversubscribed 4 times.
(4) Issuer decides to fix the ***minimum application / bid size as 20*** specified securities (falling within the range of ₹ 10,000—₹15,000). Application can be made for a minimum of 20 specified securities and in multiples thereof.
(5) Assume that a total of ***one lakh retail individual investors*** have applied in the issue, in varying number of bid lots i.e. between 1 – 16 bid lots, based on the maximum application size of upto ₹ 2,00,000.
(6) Out of the one lakh investors, there are five retail individual investors A, B, C, D and E who have applied as follows: A has applied for 320 specified securities. B has applied for 220 specified securities. C has applied for 120 specified securities. D has applied for 60 specified securities and E has applied for 20 specified securities.
(7) As per allotment procedure, the allotment to retail individual investors shall not be less than the minimum bid lot, subject to availability of shares, and the remaining available shares, if any, shall be allotted on a proportionate basis.

The ***actual entitlement*** shall be as follows:

Sr. No.	Name of Investor	Total Number of specified securities applied for	Total number of specified securities eligible to be allotted
1.	A	320	20 specified securities (i.e. the minimum bid lot) + 38 specified securities [{35,00,000 - (1,00,000 * 20)} / {140,00,000 - (1,00,000 * 20)}] * 300 (i.e. 320-20)
2.	B	220	20 specified securities (i.e. the minimum bid lot) + 25 specified securities [{35,00,000 - (1,00,000 * 20) / {140,00,000 - (1,00,000 * 20)}] * 200 (i.e. 220-20)
3.	C	120	20 specified securities (i.e. the minimum bid lot) + 13 specified securities [{35,00,000 - (1,00,000 * 20)} / {(140,00,000 - (1,00,000 * 20)}] * 100 (i.e. 120-20)
4.	D	60	20 specified securities (i.e. the minimum bid lot) + 5 specified securities [{(35,00,000 - 1,00,000 * 20)} / {(140,00,000 - (1,00,000 * 20)}] * 40 (i.e. 60-20)
5.	E	20	20 specified securities (i.e. the minimum bid lot)

Explanation

The students should note the following carefully to understand the ***above calculations*** :

(1) Every retail individual investor will get minimum 20 shares (i.e., the minimum bid lot).

(a) Total number of shares on offer for retail investors	35,00,000
(b) Total number of shares applied [35,00,000 × 4 times]	1,40,00,000
(c) Shares to be allotted first @ 20 to 1,00,000 retail investors	20,00,000
(d) Number of shares left after minimum shares allotted [35,00,000 – 20,00,000]	15,00,000

(2) The balance 15,00,000 shares to be distributed among the retail investors proportionately which will be calculated as follows :

$$\frac{\text{Number of shares available}}{[\text{Number of shares applied (b)}] - [\text{Number of shares allotted (c)}]}$$

$$\times (\text{Number of shares applied by individual}) - (\text{Numberof shares allotted})$$

Taking the case of A :

$$\frac{15,00,000}{1,40,00,000 - 20,00,000} \times (320 - 20)$$

$$= \frac{15,00,000}{1,20,00,000} \times 300 = 37.5 \text{ shares (Rounded off 38 shares)}$$

Total shares to be allotted to A :

(i) Minimum bid lot		20 shares
(ii) Proportionate entitlement		38 shares
	Total	58 shares

Taking the case of B :

$$\frac{15,00,000}{1,40,00,000 - 20,00,000} \times (220 - 20) = \frac{15,00,000}{1,20,00,000} \times 200 = 25 \text{ shares}$$

Total shares to be allotted to B :

(i) Minimum bid lot		20 shares
(ii) Proportionate entitlement		25 shares
	Total	45 shares

Taking the case of C :

$$\frac{15,00,000}{1,40,00,000 - 20,00,000} \times (120 - 20)$$

$$= \frac{15,00,000}{1,20,00,000} \times 100 = 12.5 \text{ shares (Rounded off 13 shares)}$$

Total shares to be allotted to C :

(i) Minimum bid lot		20 shares
(ii) Proportionate entitlement		13 shares
	Total	33 shares

Taking the case of D :

$$\frac{15,00,000}{1,40,00,000 - 20,00,000} \times (60 - 20) = \frac{15,00,000}{1,20,00,000} \times 40 = 5 \text{ shares}$$

Total shares to be allotted to D :

(i) Minimum bid lot		20 shares
(ii) Proportionate entitlement		05 shares
	Total	25 shares

Taking the case of E :

$$\frac{15,00,000}{1,40,00,000 - 20,00,000} \times (20 - 20) = 0 \text{ shares}$$

Total shares to be allotted to E :

(i) Minimum bid lot		20 shares
(ii) Proportionate entitlement		00 shares
	Total	20 shares

Reservation for Small Individual Applicants (An issue made other than through book building process)

Rule 43 (4) of SEBI (ICDR) Regulations states that :

In an issue made other than through the book building process, allocation in the net offer to public category shall be made as follows:

(a) minimum fifty per cent. to retail individual investors; and

(b) remaining to:
  (i) individual applicants other than retail individual investors; and
  (ii) other investors including corporate bodies or institutions, irrespective of the number of specified securities applied for;

(c) the unsubscribed portion in either of the categories specified in clauses (a) or (b) may be allocated to applicants in the other category.

Explanation: For the purpose of sub-regulation (4), if the retail individual investor category is entitled to more than fifty per cent. on proportionate basis, the retail individual investors shall be allocated that higher percentage.

Depository System

Shares are traditionally held in physical or paper form. The method has its own inherent weaknesses, e.g., loss or theft of certificates, forged or fake certificates, time consuming procedures for the transfer of shares etc. To eliminate these weaknesses, a new system called ***Depository System*** has been established. The system holds the shares in the form of electronic accounts in the same way a bank holds money for its customers. Therefore, considering its nature, a depository system has to be treated by an investor like a bank account with the only difference that the transactions are in shares instead of money.

Advantages of the Depository System

To an investor, a depository system provides the following advantages:

(1) The shares cannot be lost or stolen or mutilated.
(2) There cannot be any doubt regarding the genuineness of the shares, i.e., whether they are fake or forged.
(3) The transactions of shares can be effected immediately, i.e., faster settlements of buy or sell orders.
(4) Transaction costs are usually lower.
(5) There is no stamp duty.
(6) Paperless trading eliminate the problems of bad delivery, loss and misplace of certificates.
(7) Direct credit of allotment from public / rights / bonus issues.
(8) An investor receives the statement of accounts of his transactions / holding at regular intervals.

In India, there are two depositories : NSDL and CDSL. A depository interfaces with the investors through its agents called ***Depository Participants***.

Dematerialisation

When an investor decides to have his shares in electronic form, he should approach a Depository Participant (DP) and open an account — known as ***Demat Account***. This is similar to opening an account with any branch of a bank in order to utilise the bank's services. The investor has to surrender the share certificates in physical form, and the depository participants arranges to get them sent to and verified by the company. On confirmation, the DP credits your account with an equivalent number of shares. This is a very simple way for investors to understand its functioning as this will ensure that the right care and diligence is undertaken in the process. This process is known as ***dematerialisation***.

The most important constituent of the Demat Account is the book through which transfer of shares out of the account are made, often called the ***Delivery Instruction Book***, which has to be treated like a cheque book. Share transactions, e.g., purchase or sale of shares can be effected in a much simpler and faster way. All an investor needs to do is that after confirmation of sales / purchases transactions by the broker, the investors should approach the DP with a request to debit / credit his account for the transaction. The DP immediately arranges to complete the transaction by updating the account.

Selling of Dematerialised Securities

The procedure for selling dematerialised securities is very simple. After you have sold the securities, you would instruct your DP to debit your account with the number of securities sold by you and credit your broker's clearing account. This delivery instruction has to be given to your DP using the delivery instruction slips given to you by your DP at the time of opening the account. The procedures for selling securities is given below :

- You sell securities in any of the stock exchanges linked to NSDL / CDSL through a broker;
- You give instruction to your DP to debit your account and credit the broker's (clearing member pool) account;
- Before the pay-in day, your broker gives instruction to its DP for delivery to clearing corporation;
- Your broker receives payment from the stock exchange (clearing corporation);
- You receive payment from the broker for the sale of securities.

Purchase of Dematerialised Securities

An applicant for the issue of shares by a company should remember that no physical shares will be made available under any condition. Therefore, he needs to have a Demat Account.

For receiving demat securities you may give a one-time standing instruction to your DP. This standing instruction can be given at the time of account opening or later. Alternatively, you may choose to give separate receipt instruction every time some securities are to be received. The transactions relating to purchase of securities are summarised below :

- You purchase securities through a broker;
- You make payment to your broker who arranges payment to clearing corporation on the pay-in day;
- Your broker receives credit of securities in its clearing account (clearing member pool account) on the pay-out day;
- Your broker gives instructions to its DP to debit clearing account and credit your account;
- You receive shares into your account. However, if standing instructions are not given at the time of opening the account, you will have to give 'Receipt Instructions' to your DP for receiving credit.

You should ensure that your broker transfers the securities from its clearing account to your depository account, before the book closure. If the securities remain in the clearing account of the broker, the company will give corporate benefits (dividend or bonus) to the broker. In that case, you will have to collect the benefits from your broker.

Rematerialisation

An investor can reverse the process of dematerialisation, if he so desires, and get his shares converted into paper form. this process is known as ***Rematerialisation***. Therefore, rematerialisation is the process by which an investor can get his electronic holding converted into physical certificates.

The client has to mention the lot type (market or jumbo) in the rematerialisation request form.

Securities sent for rematerialisation cannot be traded. Before initiating a rematerialisation request in a security the client must ensure that he has sufficient free balances in that security in his depository account.

New Share Issue Procedures

Equity offerings by companies are offered to the investors in two forms :

(i) Fixed Price Offer Method
(ii) Book-building Method

Fixed Price Offer Method

In this case, the company fixes the issue price and then advertises the number of shares to be issued. If the price is very high, the investors will apply for fewer number of shares. On the other hand, if issue is under-priced, the investors will apply for more number of shares and will lead to huge oversubscription.

The ***main steps*** involved in issue of shares under '***Fixed Price Offer Method***' are the following :

(i) Selection of Merchant Banker;
(ii) Issue of a prospectus;
(iii) Receipt by the company of applications for shares;
(iv) Allotment of shares to applicants; and
(v) Issue of share certificates.

Selection of Merchant Banker : As per the provision of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 — (a) the issuer shall appoint one or more merchant bankers, at least one of whom shall be a lead merchant banker and shall also appoint other intermediaries, in consultation with the lead merchant banker, to carry out the obligations relating to the issue; (b) the issuer shall, in consultation with the lead merchant banker, appoint only those intermediaries which are registered with the Board; (c) where the issue is managed by more than one merchant banker, the rights, obligations and responsibilities, relating inter alia to disclosures, allotment, refund and underwriting obligations, if any, of each merchant banker shall be predetermined and disclosed in the offer document

The merchant bankers will do all the needful in respect of issue of shares on behalf of the company. An agreed amount is paid by the company for the service of the merchant bankers as a commission.

Issue of a Prospectus : In a 'public offer' prospectus is issued as a statutory requirement. As per the provision of ***Section 2(70)*** of the Companies Act, 2013 'prospectus' means any document described or issued as a prospectus and includes a red herring prospectus referred to in Section 32 or shelf prospectus referred to in Section 31 or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.

Rule 3 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 states that :

The Prospectus to be issued shall contain—

(a) the names, addresses and contact details of the corporate office of the issuer company, compliance officer of the issuer company, merchant bankers and co-managers to the issue, registrar to the issue, bankers to the issue, stock brokers to the issue, credit rating agency for the issue, arrangers, if any, of the instrument, names and addresses of such other persons as may be specified by the Securities and Exchange Board in its regulations;
(b) the dates relating to opening and closing of the issue;
(c) a declaration which shall be made by the Board or the Committee authorised by the Board in the prospectus that the allotment letters shall be issued or application money shall be refunded within fifteen days from the closure of the issue or such lesser time as may be specified by Securities and Exchange Board or else the application money shall be refunded to the applicants forthwith, failing which interest shall be due to be paid to the applicants at the rate of fifteen per cent per annum for the delayed period.
(d) a statement given by the Board that all monies received out of the issue shall be transferred to a separate bank account maintained with a Scheduled Bank;
(e) the details of all utilized and unutilised monies out of the monies collected in the previous issue made by way of public offer shall be disclosed and continued to be disclosed in the balance sheet till the time any part of the proceeds of such previous issue remains unutilized indicating the purpose for which such monies have been utilized, and the securities or other forms of financial assets in which such unutilized monies have been invested;

(f) the names, addresses, telephone numbers, fax numbers and e-mail addresses of the underwriters and the amount underwritten by them;

(g) the consent of trustees, solicitors or advocates, merchant bankers to the issue, registrar to the issue, lenders and experts;

Application for Shares : Application is an offer by an investor to subscribe for a specified number of shares in a company. After the publication of a prospectus, a person who wants to purchase the shares of the company has to fill in the prescribed application form. Each prospectus contains a printed application form and it states the amount per share payable on application, on allotment and on subsequent call(s). Properly filled-in application forms must be forwarded to the bankers to the issue with a cheque (A/c payee) for the amount payable on application.

An applicant may apply for shares on-line through his demat account. The amount payable on application is done through bank transfer.

Allotment of Shares to Applicants **:** Allotment is the allocation of shares to the successful applicants by the directors of a company. After the closing date, the bankers forward all applications to the company. The Board of Directors then proceed to allot all the shares. The successful applicants are sent ***letters of allotment,*** making them members of the company from the date of posting; unsuccessful applicants receive ***letters of regret,*** together with refunds of their application monies.

As per the provision of ***Section 39 of the Companies Act, 2013*** no allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.

In this respect, it is to be noted that the 'minimum subscription' in an issue shall not be less than 90% of the offer through offer document. However, this is not applicable to offer for sale of specified securities.

The amount payable on application on every security shall not be less than five per cent. of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf.

As per SEBI (ICDR) Regulations, 2009, the application money must not be less than 25% of the issue price.

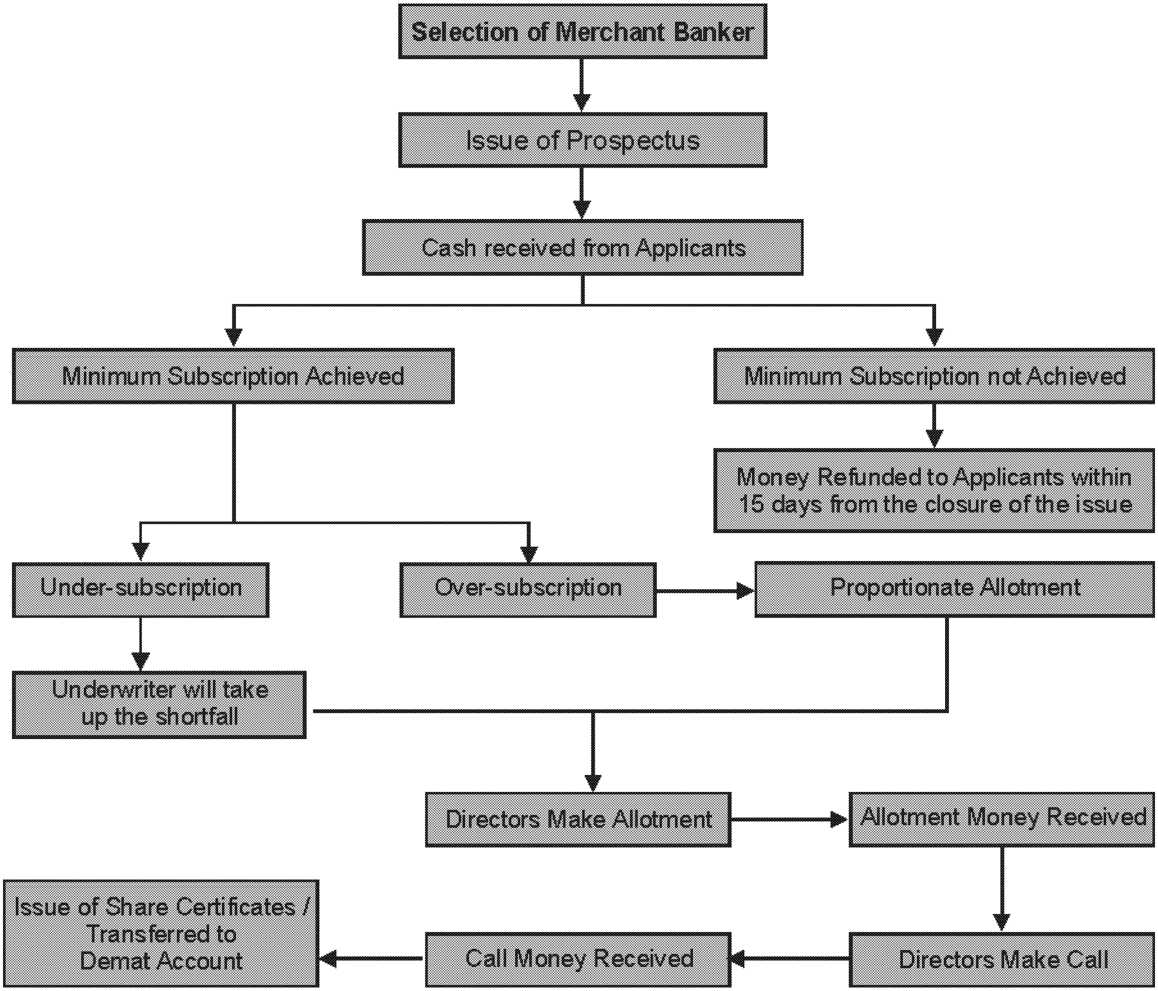
Rule 11 of the Companies (Prospectus and Allotment Securities) Rules, 2014 states that :

(1) If the stated minimum amount has not been subscribed and the sum payable on application is not received within the period specified therein, then the application money shall be repaid within a period of ***fifteen days*** from the closure of the issue and if any such money is not so repaid within such period, the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of ***fifteen percent*** per annum.

(2) The application money to be refunded shall be credited only to the bank account from which the subscription was remitted.

Share Certificate : It is a document that provides evidence of ownership of shares in a limited company. It will bear the name of the shareholder and the number and class of shares owned by the shareholder. It also states the serial number of the shares. It is stamped by the common seal of the company. It is generally signed by at least one director and the company secretary.Every certificate of share or shares shall be in Form No. SH-1. When shares are held in depository form, no share certificate in physical form is issued. The shares are transferred to demat account of the shareholders.

The different steps in connections with the issue of shares is shown in the diagram in the next page.



Book-building Method

Under this method, the company does not come out with a ***pre-determined price***. Instead, it offers the investors the opportunity to bid collectively. It then uses the bids to arrive at a ***consensus price***.

As per SEBI (ICDR) Regulations, 'book building' means a process undertaken to elicit demand and to assess the price for determination of the quantum or value of specified securities or Indian Depository Receipts, as the case may be, in accordance with these regulations.

All the applications received are arranged and a final offer price, known as '***Cut-off Price***' is arrived at. The cut-off price is at the bid price with highest demand, subject to all categories bidding at that price. At present, the book-building system is very popular in India. Presently, most IPOs in India use book-building method.

The ***main steps*** involved in the Book-building process are the following :

1. Company appoints Lead Manager (book runner) who is a category-I Merchant Banker registered with SEBI.
2. Submission of draft prospectus with SEBI.
3. Formation of syndicate of Buyers.
4. Roadshow arranged to market the issue to potential investors.

5. Lead Manager (book runner) buildings book of potential demand.
6. Lead Manager (book runner) closes the order book after consulting the issuer company.
7. Price is determined jointly by the Lead manager (book runner) and the issuer company.
8. Procurement agreement is entered between the issuer company and syndicate members.
9. Issuer company files the final prospectus with the ROC along with procurement agreement.
10. Opening of two separate bank accounts (one for private placement and another for the public subscription) by the issuer company for collection of application money.
11. Collection of application form along with necessary money.
12. Allotment of shares.
13. Receipt of approval for allotment from the Stock Exchange.
14. Receipt of permission for listing from Stock Exchanges.
15. Company get the access to the fund.

[For details, see ***Appendix — A (Page 1.82)***]

Shares Payable by Instalments

In case of 'fixed price issue', the issuer may collect the issue price in instalments or at a time. However, in case of book building issue, the entire issue price is collected at a time. The issuer may issue its shares to the public either ***at par*** or ***at a premium***.

As per the provision of Section 53 of the Companies Act, 2013 ***a company shall not issue shares at a discount*** to the public. Any share issued by a company at a discounted price shall be void. However, 'equity share' can be issued at a discount in some ***special cases***. (It has been discussed in detail in ***page 6.29.***)

The shares, whether issued at par or at a premium may be payable either by installments or in full on application. Where a company does not require the immediate use of all the proceeds from share issue, the request to have shares payable by installments is sensible. In this case, the following are the various stages in share accounting:

1. Collection of application money.
2. Allotment of shares.
3. Receipt of allotment money.
4. Share call.
5. Receipt of share call money.

Issue of Share at Par

Accounting Entries

1. On receipt of application money

*Bank Account	Dr.
To Share Application Account	

Where the share capital of the company consists of shares of different classes, a separate Share Application Account will be opened for each class of share, for example, Equity Share Application Account or Preference Share Application Account, etc.

2. On allotment of shares

(a) Share Application Account	Dr.
To Share Capital Account	

(Being application money on... shares @... each transferred to Share Capital Account as per Board's Resolution No... dated.)

It should be noted that the application money received will remain in Share Application Account unless the Board of Directors approve the allotment of shares. Only after approval, it will be treated as a part of the share capital.

Once allotment is made, the applicants will be treated as shareholders and they are legally liable to pay all monies due on shares allotted to them. ***Dues on account of share allotment and calls are accounted for on an accrual basis***. The entry is:

(b) Share Allotment Account Dr.
To Share Capital Account
(Being allotment money due on... shares @... each as per Board's Resolution No...dated...)

---

3. When shares are oversubscribed, some applications may be rejected by the Board of Directors and application money will be refunded to the applicants along with a letter of regret.

Share Application Account Dr.
To Bank Account
(Being application money on... shares @... each refunded as per Board's Resolution No... dated...)

---

4. When shares are oversubscribed, in some cases, the Board of Directors may prefer to allot less number of shares than applied for, the excess application money is adjusted against allotment money.

Share Application Account Dr.
To Share Allotment Account (Adjustment against allotment)
To Calls-in-Advance Account (Surplus after above adjustment)
To Bank Account (Surplus refunded, adjusting against allotment)

It should be noted that any surplus money, after adjusting against allotment, should be transferred to Calls-in-Advance Account, and will be adjusted when call is made. Generally, the prospectus contains a clause to this effect. If the prospectus is silent on this point, the surplus should be refunded.

5. On receipts of allotment money

* Bank Account Dr.
To Share Allotment Account
(Being allotment money received on ... shares @... each)

---

6. If some shareholders fail to pay allotment money, Allotment Account will show a debit balance. In practice, the unpaid balance is transferred to 'Calls-in-Arrear' Account. The entry is

Calls-in-Arrear Account Dr.
To Share Allotment Account
(Being the allotment money not paid transferred to Calls-in-Arrear Account)

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7. Making calls: Share call denotes a stage subsequent to allotment. Call is a demand by a company to the partly paid-up shareholders to pay a further installment towards the purchase price of shares. There may be more than one call at intervals. The dates on which calls are due are usually specified in the prospectus. Where no dates are specified, Table A regulates subsequent calls. Whenever a call is made, details connected thereto are recorded in a 'Share Call Book'. Different calls are distinguished from each other by serial numbers, for example, First call, Second call, and so on. ***Dues on account of share call are also accounted for on an accrual basis.***

Share Call Account Dr.
To Share Capital Account
(Being call money due on ... shares @ ... each as per Board's Resolution No... dated...)

---

8. On receipt of call money

*Bank Account Dr.
To Share Call Account
(Being call money received on ... shares @ ... each)

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9. Non-payment of call money

Calls-in-Arrear Account Dr.
To Share Call Account
(Being Call money on... shares @... each transferred to Calls-in-Arrear Account for non payment)

10. On adjustment of 'calls-in-advance', if any

Calls-in-Advance Account Dr.
To Share Call Account
(Being the adjustment for calls-in-advance)

*** *All monies received shall be kept in a separate Bank Account maintained with a scheduled bank.***

Application and Allotment Account and Call Accounts — are in fact total or control accounts on shares issues. The detailed entries will be made in the Memorandum Accounts of individual shareholder and total amounts only entered in the above mentioned accounts.

In practice, all cash transactions are directly recorded in the Cash Book in the following manner.

Dr. **Cash Book (without narration)** **Cr.**

To Share Application A/c	****	By Share Application A/c (Refund)	****
To Share Allotment A/c	****		
To Share First Call A/c	****		
To Share Final Call A/c	****		

Illustration 4

Bharat Electronics Ltd issued 1,00,000 equity shares of ₹ 10 each to the public at par. The details of the amount payable on the shares are as follows :

Date	Call	₹ per share
1st April, 2017	Application	2.00
1st June, 2017	Allotment	3.00
1st July, 2017	Final Call	5.00

Application monies were received on 1,20,000 shares. Excess application monies were refunded immediately. All other amounts were received excepting final call money on 1,000 shares.

Pass Journal Entries (including cash/bank transactions) to record the above in the books of Bharat Electronics Ltd

Solution **In the books of Bharat Electronics Ltd**

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
2017 April 1	Bank A/c Dr. To Equity Share Application A/c (Being application money received on 1,20,000 shares @ ₹ 2 each)	2,40,000	 2,40,000
?	Equity Share Application A/c Dr. To Equity Share Capital A/c To Bank A/c (Being application money on 1,00,000 shares @ ₹ 2 transferred to Equity Share Capital Account and application money on 20,000 shares refunded to applicants as per Board's Resolution No. . . . dated . . .)	2,40,000	 2,00,000 40,000
?	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Being allotment money due on 1,00,000 shares @ ₹ 3 each as per Board's Resolution No. . . . dated . . .)	3,00,000	 3,00,000
June 1	Bank A/c Dr. To Equity Share Allotment A/c (Being allotment money received on 1,00,000 shares @ ₹ 3 each)	3,00,000	 3,00,000
?	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being final call money due on 1,00,000 shares @ ₹ 5 each as per Board's Resolution No. . . . dated . . .)	5,00,000	 5,00,000
July 1	Bank A/c Dr. To Equity Share Final Call A/c (Being final call money received on 99,000 shares @ ₹ 5 each)	4,95,000	 4,95,000

Tutorial Note : Amount due on final call ₹ 5,000 can be transferred to Calls-in-Arrear Account by passing the following entry :

Calls-in-Arrear Account Dr.
To Equity Share Final Call Account

After passing the above entry, Equity Share Final Call Account will be closed totally.

Issue of Securities at a Premium

The term 'premium' has not been defined in the Companies Act. Price received over the face value of the shares is treated as premium. A company, if a market exists, can issue shares at a premium. Very recently shares of ₹ 10 have been issued by INOX India Limited at a premium of more than ₹ 300.

Section 52 of the Companies Act, 2013 states that :

(1) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall, except as provided in this section, apply as if the securities premium account were the paid-up share capital of the company.

(2) Notwithstanding anything contained in sub-section (1), the securities premium account may be applied by the company—
   - (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
   - (b) in writing off the preliminary expenses of the company;
   - (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
   - (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
   - (e) for the purchase of its own shares or other securities under section 68 (Buy-back of shares).

(3) The securities premium account may, notwithstanding anything contained in sub-sections (1) and (2), be applied by such class of companies, as may be prescribed and whose financial statement comply ***with the accounting standards*** prescribed for such class of companies under section 133,—
   - (a) in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or
   - (b) in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company; or
   - (c) for the purchase of its own shares or other securities under section 68 (Buy-back of shares).

Accounting Entries

Premium may be collected with application money or on allotment or along with a subsequent call. Generally, premium is collected along with allotment money.

(i) When premium is collected along with application money

(a) Bank Account Dr. [Total amount received on application]
    To Share Application Account
(b) Share Application Account Dr.
    To Share Capital Account
    To Securities Premium Account

[All other entries in respect of allotment and calls are same as shares issued at par]

(ii) When premium is collected along with allotment money:

(a) Bank Account Dr.
    To Share Application Account
(b) Share Application Account Dr.
    To Share Capital Account
(c) Share Allotment Account Dr.
    To Share Capital Account
    To Securities Premium Account

[All other entries in respect of calls are the same as shares issued at par]

Illustration 5

The authorized capital of a company is 1,00,000 shares of ₹ 10 each. On April 10, 2016, 50,000 shares are issued for subscription at a premium of ₹ 2 per share. The share money is payable as follows : ₹ 5 (including the premium of ₹ 2) with application, ₹ 3 on allotment, ₹ 2 on first call, and ₹ 2 on final call.

The subscription list closes on May 11, 2016, and the directors proceed with allotment on May 18, 2016. The shares are fully subscribed and the application money (including the premium) is received in full. The allotment money is received by June 30, 2016, except as regards 500 shares.

The first call and the final call money is received by September 30, 2016, and December 31, 2016, respectively, barring the final call money on 200 shares which is not received.

Pass necessary Journal Entries (excluding cash) and show the Cash Book.

Solution

In the books of the Company

Cash Book (Bank column only)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 May 11	To Share Application A/c (Being application money received on 50,000 shares @ ₹ 5 each including premium of ₹ 2 per share)	2,50,000	2016 Dec 31	By Balance c/d	5,96,100
June 30	To Share Allotment A/c (Being allotment money received on 49,500 shares @ ₹ 3 each)	1,48,500			
Sept. 30	To Share First Call A/c (Being First Call money received on 49,500 shares @ ₹ 2 each)	99,000			
Dec. 31	To Share Final Call A/c (Being Final Call money received on 49,300 shares @ ₹ 2 each)	98,600			
		5,96,100			5,96,100

Journal

Dr. **Cr.**

Date	Particulars		₹	₹
2016	Share Application A/c	Dr.	2,50,000	
May 18	To Share Capital A/c			1,50,000
	To Securities Premium A/c			1,00,000
	(Being application money transferred to Share Capital Account @ ₹ 3 each and to Securities Premium Account @ ₹ 2 each for 50,000 shares as per Board's Resolution No. ... dated ...)			
?	Share Allotment A/c	Dr.	1,50,000	
	To Share Capital A/c			1,50,000
	(Being allotment money due on 50,000 shares @ ₹ 3 each as per Board's Resolution No. ... dated ...)			
?	Share 1st Call A/c	Dr.	1,00,000	
	To Share Capital A/c			1,00,000
	(Being 1st call money due on 50,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
?	Share Final Call A/c	Dr.	1,00,000	
	To Share Capital A/c			1,00,000
	(Being 2nd and Final Call money due on 50,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
?	Calls-in-Arrear A/c	Dr.	3,900	
	To Share Allotment A/c (500 x ₹ 3)			1,500
	To Share First Call A/c (500 x ₹ 2)			1,000
	To Share Final Call A/c (700 x ₹ 2)			1,400
	(Being the money not paid transferred to Calls-in-Arrear Account)			

Illustration 6

Dynamic Ltd issued 10,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share. The amount payable as: ₹ 2 on application; ₹ 5 on allotment (including premium) and the rest on first and final call. Applications were received for 12,000 shares. Excess application money were refunded to applicants. All monies due were received except the first and final call monies on 1,000 shares.

Show the Journal and Cash Book entries in the books of Dynamic Ltd

Solution

In the books of Dynamic Ltd

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being application money received on 12,000 shares @ ₹ 2 per share)	24,000		By Equity Share Application A/c (Being application money for 2,000 shares refunded as per Board's Resolution No ... Dated ...)	4,000
	To Equity Share Allotment A/c (Being allotment money received on 10,000 shares @ ₹ 5 each)	50,000		By Balance c/d	1,15,000
	To Equity Share First & Final Call A/c (Being Final Call money received on 9,000 shares @ ₹ 5 each)	45,000			
		1,19,000			1,19,000

Journal **Dr.** **Cr.**

Date	Particulars		₹	₹
	Equity Share Application A/c	Dr.	20,000	
	To Equity Share Capital A/c			20,000
	(Being application money on 10,000 shares @ ₹ 2 per share transferred to Equity Share Capital Account as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	50,000	
	To Equity Share Capital A/c			30,000
	To Securities Premium A/c			20,000
	(Being allotment money due on 10,000 shares @ ₹ 5 each including premium of ₹ 2 per share as per Board's Resolution No. ... dated ...)			
	Equity Share First & Final Call A/c	Dr.	50,000	
	To Equity Share Capital A/c			50,000
	(Being final call money due on 10,000 shares @ ₹ 5 each as per Board's Resolution No. ... dated ...)			
	Calls-in-Arrear A/c	Dr.	5,000	
	To Equity Share First & Final Call A/c			5,000
	(Being first & final call money not paid for 1,000 shares @ ₹ 5 each transferred to Calls-in-Arrear Account)			

Issue of Sweat Equity Shares

As per the provision of ***Section 2(88) of the Companies Act, 2013,*** 'sweat equity shares' means such equity shares as are issued by a company to its directors or employees at a ***discount*** or for consideration, other than for cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

It should be noted that all unlisted and private companies will have to follow Rule 8 of the Companies (Share Capital and Debentures) Rules, 2014 for the issue of sweat equity shares. However, the listed companies should follow the regulations of SEBI.

Rule 8 of the Companies (Share Capital and Debentures) Rules, 2014

Some of the important rules are given below :

(1) The issue of sweat equity shares must be authorised by a ***special resolution*** passed by the company in a general meeting. This resolution will remain valid for 12 months.

(2) The company shall not issue sweat equity shares for more than ***fifteen percent*** of the existing paid up equity share capital in a year or shares of the issue value of rupees ***five crores***, whichever is higher: Provided that the issuance of sweat equity shares in the Company shall not exceed ***twenty five percent,*** of the paid up equity capital of the Company at any time.

(3) The sweat equity shares issued to directors or employees shall be locked in/non transferable for a period of ***three years*** from the date of allotment and the fact that the share certificates are under lock-in

and the period of expiry of lock in shall be stamped in bold or mentioned in any other prominent manner on the share certificate.

(4) The sweat equity shares to be issued shall be valued at a price determined by a registered valuer as the fair price giving justification for such valuation.

(5) The valuation of intellectual property rights or of know how or value additions for which sweat equity shares are to be issued, shall be carried out by a registered valuer, who shall provide a proper report addressed to the Board of directors with justification for such valuation.

(6) Where sweat equity shares are issued for a non-cash consideration on the basis of a valuation report in respect thereof obtained from the registered valuer, such non-cash consideration shall be treated in the following manner in the books of account of the company-

(a) where the non-cash consideration takes the form of a depreciable or amortizable asset, it shall be carried to the balance sheet of the company in accordance with the accounting standards; or

(b) where clause (a) is not applicable, it shall be expensed as provided in the accounting standards.

(7) The amount of sweat equity shares issued shall be treated as part of managerial remuneration for the purposes of sections 197 and 198 of the Act, if the following conditions are fulfilled, namely.-

(a) the sweat equity shares are issued to any director or manager; and

(b) they are issued for consideration other than cash, which does not take the form of an asset which can be carried to the balance sheet of the company in accordance with the applicable accounting standards.

(8) In respect of sweat equity shares issued during an accounting period, the accounting value of sweat equity shares shall be treated as a form of compensation to the employee or the director in the financial statements of the company, if the sweat equity shares are not issued pursuant to acquisition of an asset.

SEBI (Issue of Sweat Equity Shares) Regulation, 2002

All ***listed*** companies and the unlisted companies coming out with IPO and seeking listing of its securities on the stock exchange shall comply with these regulations. Some of the important regulations are given below :

(1) The issue of sweat equity shares to employees or directors should be approved by a ***special resolution***.

(2) In case of issue of sweat equity shares to promoters, the same shall also be approved by ***simple majority*** of the shareholders in general meeting.

(3) Each transaction of issue of sweat equity shall be voted by a separate resolution.

(4) the validity of the resolution is not more than 12 months from the date of adopting it.

(5) The price of sweat equity shares shall not be less than the higher of the following :

(a) the average of the weekly high and low of the closing prices of the related equity shares during ***last six months*** preceding the relevant date; or

(b) the average of the weekly high and low of the closing prices of the related equity shares during the ***two weeks*** preceding the relevant date.

Explanation : 'Relevant date' for this purpose means the date which is thirty days prior to the date on which the meeting of the General Body of the shareholders is convened.

(6) Where the sweat equity shares are issued for a non-cash consideration, such non-cash consideration shall be treated in the following manner in the books of account of the company :

(a) where the non-cash consideration take the form of a depreciable or amortizable asset, it shall be carried to the Balance Sheet of the company in accordance with the relevant accounting standards; or

(b) where clause (a) is not applicable, it shall be expensed as provided in the relevant accounting standards.

(7) In the general meeting subsequent to the issue of sweat equity, the Board of Directors shall place before the shareholders, a certificate from the auditors of the company that the issue of sweat equity shares has been made in accordance with the Regulations and in accordance with the resolution passed by the company authorising the issue of such sweat equity shares.

(8) The sweat equity shares shall be locked-in for a period of 3 years from the date of allotment.

Manner of Calls

If the issuer proposes to receive subscription monies in calls, it shall ensure that the outstanding subscription money is called within ***twelve months*** from the date of allotment in the issue and if any applicant fails to pay the call money within the said ***twelve months***, the equity shares on which there are calls in arrear along with the subscription money already paid on such shares shall be ***forfeited***.

No call shall exceed 1/4th of the nominal value of the shares or be payable at less than one month from the date fixed for the payment of the last preceding call.

Calls-in-Arrear

Calls-in-arrear refer to that portion of the capital, which has been called up but not yet paid by the shareholders. When a shareholder(s) fails to pay the amount due on allotment and/or calls, the Allotment Account and/or Calls Account will show debit balance(s) equal to the total unpaid amounts of each installment. Generally, such amount is transferred to a special account called 'Calls-in-Arrear Account'. For example, a company has not received allotment money @ ₹ 3 per share on 100 shares and first call money @ ₹ 2 per share on 200 shares. These amounts of ₹ 300 (₹ 3 x 100) and ₹ 400 (₹ 2 x 200) due on allotment and first call respectively are called Calls-in-Arrear. The main purpose of opening a Calls-in-Arrear Account is to close allotment or any other Calls Account with the amounts not yet received.

The ***entry*** will be:

Calls-in-Arrear Account Dr.
    To Share Allotment Account
    To Share Call Account

When money is collected from such defaulting shareholders, the following ***entry*** is passed:

Bank Account Dr.
    To Calls-in-Arrear Account

The balance of 'Calls-in-Arrear Account', at the year end, is shown in the Balance Sheet as a deduction from respective Share Capital Account. It is shown in the Balance Sheet until the shares on which money unpaid are forfeited. At the time of forfeiture of shares, the entry will be :

Share Capital Account Dr.
    To Calls-in-Arrear Account

Interest on calls-in-arrear :

Interest on calls-in arrear may be collected by the directors from the shareholders, if the Articles of Association so provide. If the company has adopted 'Table F', then it can charge interest @ 10% p.a. from the due date to the date of actual payment, the Board shall be at liberty to waive payment of any such interest wholly or in part. [***See Illustration** 7*]

Accounting Entries

(a) For interest due

Shareholders Account Dr.
    To Interest on Calls-in-Arrear Account

(b) When Interest in actually realised

Bank Account Dr.
    To Shareholders Account

(c) For transferring interest to profit and loss account

Interest on Calls-in-Arrear Account Dr.
    To Statement of Profit and Loss

Calls-in-Advance

Section 50 of the Companies Act, 2013 states that :

(1) A company may, if so authorised by its articles, accept from any member, the whole or a part of the amount remaining unpaid on any shares held by him, even if no part of that amount has been called up.

(2) A member of the company limited by shares shall not be entitled to any voting rights in respect of the amount paid by him under sub-section (1) until that amount has been called up.

Calls in advance generally arises when there is an over subscription of shares. Here, the excess application money received is adjusted against the amount due on allotment or calls. The excess application money after adjustment for allotment should be transferred to a special account called ***'Calls-in-Advance Account'***, if the prospectus so provides. Sometimes, to avoid the botheration of paying calls from time to time, some shareholders may prefer to pay the entire amount at the time of allotment. In such a situation, the advance money in respect of future call(s) should also be transferred to ***Calls-in-Advance Account*** and it is adjusted when calls are made.

Accounting Entries :

(a) For transferring excess application money

Share Application Account	Dr. [Adjustment for excess]
To Calls-in -Advance Account	

(b) For money received in advance against call

Bank Account	Dr.
To Calls-in-Advance Account	

(c) For adjusting with call(s)

Calls-in-Advance Account	Dr.
To Call(s) Account	

It should be noted that Calls-in-Advance does not form a part of the company's share capital and no dividend is payable on such amount. In the Balance Sheet, it should be shown on the 'Equity and Liabilities' section as Current Liabilities

Interest on Calls-in-Advance

Interest may be paid on calls-in-advance if Articles of Association so provide. If the company has adopted 'Table F', then it is required to pay interest @ 12% p.a. from the date of receipt to the due date.

(a) For interest due on calls-in-advance

Interest on Calls-in-Advance Account	Dr.
To Shareholders Account	

(b) For payment of interest

Shareholders Account	Dr.
To Bank Account	

(c) For closing interest on calls-in-advance account

Profit and Loss Account	Dr.
To Interest on Calls-in-Advance Account	

Illustration 7

X Ltd makes an issue of 10,000 equity shares of ₹ 10 each payable as follows:
₹ 2 on application; ₹ 3 on allotment; and ₹ 5 on first and final call (3 months after allotment).

Applications were received for 12,000 shares and the directors refunded the excess application money. One shareholder, who was allotted 20 shares paid first and final call with allotment money and another shareholder did not pay allotment money on his 30 shares but which he paid with first and final call.

Directors have decided to charge and allow interest, as the case may be, on calls-in-arrears and calls-in-advance respectively according to the provisions of Table - F of Schedule I to the Companies Act, 2013.

Show Journal Entries and Cash Book [without narration] in the books of the company.

Solution

In the books of X Ltd

Dr. Cash Book Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c	24,000.00		By Equity Share Application A/c	4,000.00
	To Equity Share Allotment A/c	29,910.00		By Shareholders A/c (₹ 100 x 12% x 3/12)	3.00

	To Calls-in-Advance A/c (₹ 5 x 20)	100.00		By Balance c/d	99,999.25
	To Equity Share First and Final Call A/c	49,900.00			
	To Calls-in-Arrear A/c	90.00			
	To Shareholders A/c (90 x 10% x 3/12)	2.25			
		1,04,002.25			1,04,002.25

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Equity Share Application A/c	Dr.	20,000	
	To Equity Share Capital A/c			20,000
	(Being application money transferred to Equity Share Capital Account as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	30,000	
	To Equity Share Capital A/c			30,000
	(Being allotment money due on 10,000 shares @ ₹ 3 each as per Board's Resolution No. ... dated ...)			
	Calls-in-Arrear A/c	Dr.	90	
	To Equity Share Allotment A/c			90
	(Being the non-receipt of allotment money on 30 shares transferred to Calls-in-Arrear Account)			
	Interest on Calls-in-Arrears A/c	Dr.	3.00	
	To Shareholders A/c			3.00
	(Being interest due on calls-in-advance @ 12% p.a.)			
	Shareholders A/c	Dr.	2.25	
	To Interest on Calls-in-Arrear A/c			2.25
	(Being interest due @ 10% on calls-in-arrear of ₹ 90)			
	Equity Share First and Final Call A/c	Dr.	50,000	
	To Equity Share Capital A/c			50,000
	(Being the final call money due on 10,000 shares @ ₹ 5 each as per Board's Resolution No ... dated ...)			
	Calls-in-Advance A/c	Dr.	100	
	To Equity Share First and Final Call A/c			100
	(Being the Calls-in-Advance adjusted against the amount due on first and final call)			

Illustration 8

A company made an issue of 10,000 equity shares of ₹ 10 each, payable as: ₹ 3 on application; ₹ 4 on allotment and the balance on call. 43,825 equity shares were applied for including on application for 300 shares from a person who paid for the full face value of the shares. Owing to over-subscription, allotments were scaled down as follows:

Applicants for 11,825 equity shares (in respect of applications for 500 or less) received 5,750 equity shares (including the application for 300 shares who got 150 equity shares). Applicants for 32,000 shares (in respect of applications for 500 equity shares), received 4,250 equity shares. The amounts received were first applied towards allotment and call money (after satisfying amount due on application) and any balance left was returned.

You are required to show the Cash Book (without narration) and Ledger Accounts to record the above transactions.

[I.C.W.A. (Inter) — Adapted]

Solution

In the books of the Company

Cash Book

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c	1,33,575		By Equity Share Application A/c	55,000
	To Equity Share Allotment A/c	4,625		By Balance c/d	1,00,000
	To Equity Share Call A/c	16,800			
		1,55,000			1,55,000

Dr. **Equity Share Application Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	30,000		By Bank A/c	1,33,575
	To Equity Share Allotment A/c	35,375			
	To Calls-in-Advance A/c	13,200			
	To Bank A/c	55,000			
		1,33,575			1,33,575

Dr. **Calls-in-Advance Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Call A/c	13,200		By Equity Share Application A/c	13,200

Dr. **Equity Share Allotment Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	40,000		By Equity Share Application A/c By Bank A/c	35,375 4,625
		40,000			40,000

Dr. **Equity Share Call Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	30,000		By Calls-in-Advance A/c By Bank A/c	13,200 16,800
		30,000			30,000

Dr. **Equity Share Capital Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	1,00,000		By Equity Share Application A/c By Equity Share Allotment A/c By Equity Share Call A/c	30,000 40,000 30,000
		1,00,000			1,00,000

Working Note: (1) Calculation for Adjustment and Refund:

Category	No. of Shares Applied for	No. of Shares Allotted	Amount recd. on Appli.-cation	Amount due on Appli-cation & Allotment	Balance Amount due on Allotment	Surplus trans-ferred to Calls-in-Advance	Amount refunded	Amount due on Call	Calls-in-Advance adjusted against call	Amount received on Call
1.	300	150	* 3,000	1,050	—	450	** 1,500	450	450	—
2.	#11,525	#5,600	34,575	39,200	4,625	—	—	16,800	—	16,800
3.	32,000	4,250	96,000	29,750	—	12,750	53,500	12,750	12,750	—
TOTAL	43,825	10,000	1,33,575	70,000	4,625	13,200	55,000	30,000	13,200	16,800

* For 300 shares full amount @ ₹ 10 was received.

** Only 150 shares were allotted. Therefore, full money on balance 150 shares will be refunded.

Applicants for 11,825 shares were allotted 5,750 shares, which includes an applicant for 300 shares, who was allotted 150 shares. Therefore, applicants for 11,525 (11,825 – 300) shares were allotted 5,600 (5,750 – 150) shares.

Forfeiture of Shares

The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay a call money results in forfeiture of shares. Forfeiture of shares is the action taken by a company to cancel the shares. The directors are usually empowered by the Articles of Association to forfeit those shares by serving proper notice to the defaulting shareholder(s).

When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date in not refunded to him. The shareholder then has no further claim on the company. The power of forfeiture must be exercised strictly having regard to the rules and regulations provided in the Articles of Association and it should be ***bona fide*** in the interests of the company.

Generally, the Articles of Association lay down the procedure to be followed at the time of forfeiture. If so desired, regulations given in **Table F** can be adopted as model regulations. These regulations are as under:

Schedule — I of the Companies Act, 2013
Table — F : Forfeiture of Shares

28. If a member fails to pay any call, or installment of a call, on the day appointed for payment thereof, the Board may, at any time thereafter during such time as any part of the call or installment remains unpaid, serve a notice on him requiring payment of so much of the call or installment as is unpaid, together with any interest which may have accrued.

29. The notice aforesaid shall :
(a) name a further day (not being earlier than the expiry of fourteen days from the date of service of the notice) on or before which the payment required by the notice is to be made; and; (b) states that,

in the event of non-payment on/or before the date so named, the shares in respect of which the call was made will be liable to be forfeited.

30. If the requirement of any such notice as aforesaid are not complied with, any share in respect of which the notice has been given may, at any time thereafter, before the payment required by the notice has been made, be forfeited by a resolution of the Board to that effect.

31. (i) A forfeited share may be sold or otherwise disposed of on such terms and in such manner as the Board thinks fit.

(ii) At any time before a sale or disposal as aforesaid, the Board may cancel the forfeiture on such terms as it thinks fit.

32 (i) A person whose shares have been forfeited shall cease to be a member in respect of the forfeited shares, but shall notwithstanding the forfeiture, remain liable to pay to the company all moneys which, at the date of forfeiture, were presently payable by him to the company in respect of the shares; and

(ii) The liability of such person shall cease if and when the company shall have received payment in full of all such moneys in respect of the shares.

Accounting Entries

At the time of passing entry for forfeiture of shares, students must be careful about the following matters :

(i) Amount called-up (i.e., amount credited to capital) in respect of forfeited shares.

(ii) Amount already received in respect of those shares.

(iii) Amount due but has not been received in respect of those shares.

We know that shares can be issued at par or at a premium. Accounting entries for forfeiture will vary according to situations.

Situation 1 : Forfeiture of Shares which were Issued at Par

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. Allotment or Calls Account will be credited with the amount due but not paid by the shareholder(s). (Alternatively, Calls-in-Arrear Account can be credited for all amount due, if it was transferred to Calls-in- Arrear Account). Forfeited Shares Account will be credited with the amount already received in respect of those shares.

Share Capital Account	Dr. [No. of shares x called-up value per share]
To Share Allotment Account	[Amount due, but not paid]
To Share First Call Account	[Amount due, but not paid]
To Share Final Call Account	[Amount due, but not paid]
To Forfeited Shares Account	[Amount received]

Where all amounts due on allotment, first call and final call have been transferred to Calls-in-Arrear Account, the entry will be :

Share Capital Account	***Dr. [No. of Shares x Called-up Value per share]***
To Calls-in-Arrear Account	***[Total amount due, but not paid]***
To Forfeited Shares Account	***[Amount received]***

Illustrative Example 1

A Ltd forfeited 300 equity shares of ₹ 10 each fully called-up, held by Mr X for non-payment of final call @ ₹ 4 each. However, he paid application money @ ₹ 2 per share and allotment money @ ₹ 4 per share. These shares were originally issued at par. Give Journal Entry for the forfeiture.

Solution

In the books of A Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Equity Share Capital A/c (300 x ₹ 10)	Dr.	3,000	
	To Equity Share Final Call A/c (300 x ₹ 4)			1,200
	To Forfeited Shares A/c (300 x ₹ 6)			1,800
	(Being the forfeiture of 300 equity shares of ₹ 10 each fully called-up for non-payment of final call money @ ₹ 4 each as per Board's Resolution No. . . . dated . . .)			

Illustrative Example 2

X Ltd forfeited 200 equity shares of ₹ 10 each, ₹ 8 called-up for non-payment of first call money @ ₹ 2 each. Application money @ ₹ 2 per share and allotment money @ ₹ 4 per share have already been received by the company. Give Journal Entry for the forfeiture (assume that all money due has been transferred to Calls-in-Arrear Account).

Solution **In the books of X Ltd**

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Equity Share Capital A/c (200 x ₹ 8) [See Tutorial Note] Dr.	1,600	
	To Calls-in-Arrear A/c (200 x ₹ 2)		400
	To Forfeited Shares A/c (200 x ₹ 6)		1,200
	(Being the forfeiture of 200 equity shares of ₹ 10 each, ₹ 8 called-up for non-payment of first call money @ ₹ 2 each as per Board's Resolution No. . . . dated . . .)		

Tutorial Note : The Share Capital Account will be debited with the amount called-up only. In this case, the called-up amount is ₹ 8. Therefore, ₹ 8 per share forfeited will be debited to Share Capital Account.

Situation 2 : Forfeiture of Shares which were Issued at a Premium

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. If the premium on such shares has not been paid by the shareholder, the Securities Premium Account will be debited to cancel it (if it was credited earlier). Allotment, Calls and Forfeited Accounts will be credited in the usual manner.

Students should note that if the premium has already been received by the company, it cannot be cancelled even if the shares are forfeited in the future.

Illustrative Example 3

X Ltd forfeited 500 equity shares of ₹ 10 each fully called-up which were issued at a premium of 20%. Amount payable on shares were : on application ₹ 2; on allotment ₹ 5 (including premium) on First and Final Call ₹ 5. Only application money was paid by the shareholders in respect of these shares. Pass Journal Entries for the forfeiture.

Solution **In the books of X Ltd**

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Equity Share Capital A/c (500 x ₹ 10) Dr.	5,000	
	Securities Premium A/c (See Note) Dr.	1,000	
	To Equity Share Allotment A/c (500 x ₹ 5)		2,500
	To Equity Share First and Final Call A/c (500 x ₹ 5)		2,500
	To Forfeited Shares A/c (500 x ₹ 2)		1,000
	(Being the forfeiture of 500 equity shares of ₹ 10 each fully called-up, issued at a premium of 20%, for non-payment of allotment and call money as per Board's Resolution No. . . . dated . . .)		

Tutorial Note : Share premium @ ₹ 2 on 500 shares has not been received by the company. Therefore, at the time of forfeiture, Securities Premium Account will be debited to cancel it (because Securities Premium Account was credited at the time of allotment).

Illustration 9

B.Ltd issued 20,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share payable as follows : on application ₹ 5; on allotment ₹ 5 (including premium); on final call ₹ 2. Applications were received for 24,000 shares. Letters of regret were issued to applicants for 4,000 shares and were allotted to all the other applicants. Mr.A, the holder of 150 shares, failed to pay the allotment money. On his subsequent failure to pay the call money, the shares were forfeited. Show the Journal Entries and Cash Book in the books of B. Ltd

Solution **In the books of B Ltd**

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being application money received on 24,000 shares @ ₹ 5 each)	1,20,000		By Equity Share Application A/c (Being excess money refunded on 4,000 shares @ ₹ 5 each as per Board's Resolution No... dated ...)	20,000
	To Equity Share Allotment A/c (Being allotment money received on 19,850 shares @ ₹ 5 each)	99,250		By Balance c/d	2,38,950

	To Equity Share Final Call A/c (Being final call money received on 19,850 shares @ ₹ 2 each)	39,700			
		2,58,950			2,58,950

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being application money on 20,000 shares @ ₹ 5 each transferred to Equity Share Capital Account as per Board's Resolution No. ... dated ...)	1,00,000	 1,00,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being allotment money due on 20,000 shares @ ₹ 5 each including premium as per Board's Resolution No. ... dated ...)	1,00,000	 60,000 40,000
	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being final call money due on 20,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)	40,000	 40,000
	Equity Share Capital A/c (150 x ₹ 10) Dr. Securities Premium A/c (150 x ₹ 2) Dr. To Equity Share Allotment A/c To Equity Share Final Call A/c To Forfeited Shares A/c (Being forfeiture of 150 shares for non-payment of allotment money and final call money as per Board's Resolution No. ... dated ...)	1,500 300	 750 300 750

Tutorial Note : Here, securities premium on forfeited shares has not been realised, so Securities Premium Account will be debited at the time of forfeiture of these shares.

Forfeiture of Fully Paid-up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realisation of debts of the shareholder if the Articles specifically provide it. [Sri Gopal Jalan & Co. vs. Calcutta Stock Exchange Association Ltd; ***Naresh Chandra Sanyal vs. Calcutta Stock Exchange Association Ltd.***]

Re-issue of Forfeited Shares

A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Re-issue of forfeited shares is not allotment of shares but only a sale.

The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it of. However, the directors are not bound to sell shares forfeited for non-payment of call as has been decided in the case of ***Bishambhar Nath vs. Agra Electric Stores Ltd***.

In practice, forfeited shares are disposed of by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrear on those shares.

If the shares are re-issued at price which is more than the face value, the excess amount is not payable to the original shareholder. This amount is to be transferred to '***Securities Premium Account***'. If the share are re-issued at a price which is less than called-up amount, the loss should be adjusted against Forfeited Shares Account. The balance of Forfeited Shares Account, after re-issue, is transferred to Capital Reserve account.

Accounting Entries:

(a) Bank Account Dr.[Actual amount received]
Forfeited Shares Account Dr.[Loss on re-issue]
To Share Capital Account
(Being the re-issue of ...shares @ ₹...each as per Board's Resolution No... dated.)

(b) Forfeited Shares Account Dr.
To Capital Reserve Account
(Being the profit on re-issue transferred to capital reserve).

In connection with re-issue, the following points are important :

1. ***Loss on re-issue should not exceed the forfeited amount.***
2. ***If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.***
3. ***The forfeited amount on shares not yet reissued should be shown in the Balance Sheet as an addition to the share capital.***
4. ***When only a portion of the forfeited shares are re-issued, then the profit made on reissue of such shares must be transferred to Capital Reserve.***
5. ***When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".***
6. ***If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.***
7. ***If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.***

Illustration 10

Give separate Journal Entries for the following :

(a) X Ltd forfeited 100 equity shares of ₹ 10 each held by R Ram on 15th December, 2016 for non-payment of first call of ₹ 2 per share and the final call of ₹ 3 per share. These shares were re-issued to G Ram on 25th December, 2016 @ ₹ 6.50 per share.

(b) X Ltd forfeited 100 equity shares of ₹ 10 each, issued at a premium of ₹ 5 per share, held by M Ram on 15th December, 2016, for non-payment of the final call of ₹ 3 per share. These shares were re-issued to Loknath on 25th December, 2016 @ ₹ 6 per share.

(c) X Ltd forfeited 150 equity shares of ₹ 10 each issued at a premium of ₹ 5 per share, held by K Ram on 15th December, 2016, for non-payment of allotment money of ₹ 8 per share (including securities premium of ₹ 5 per share), the first call of ₹ 2 per share and the final call of ₹ 3 per share. Out of these 100 equity shares were re-issued to Shri Bhagwan at ₹ 15 per share on 25th December, 2016.

Solution

In the books of X Ltd
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016 (a)	Equity Share Capital A/c (100 x ₹ 10)	Dr.	1,000	
Dec. 15	To Equity Share First Call A/c (100 x ₹ 2)			200
	To Equity Share Final Call A/c (100 x ₹ 3)			300
	To Forfeited Shares A/c			500
	(Being the forfeiture of 100 equity shares of ₹ 10 each fully called-up for non-payment of first call of ₹ 2 and final call of ₹ 3 per share as per Board's Resolution No. ... dated ...)			
Dec. 25	Bank A/c (100 x ₹ 6.50)	Dr.	650	
	Forfeited Shares A/c (100 x ₹ 3.50)	Dr.	350	
	To Equity Share Capital A/c			1,000
	(Being re-issue of 100 shares @ ₹ 6.50 per share as fully paid-up as per Board's Resolution No. ... dated ...)			
Dec. 25	Forfeited Shares A/c : ₹ (500 – 350)	Dr.	150	
	To Capital Reserve A/c			150
	(Being profit on re-issue transferred to Capital Reserve)			
2016 (b)	Equity Share Capital A/c (100 x ₹ 10)	Dr.	1,000	
Dec. 15	To Equity Share Final Call A/c (100 x ₹ 3)			300
	To Forfeited Shares A/c			700
	(Being the forfeiture of 100 equity shares for non-payment of final call of ₹ 3 per share as per Board's Resolution No. ... dated ...)			
Dec. 25	Bank A/c (100 x ₹ 6)	Dr.	600	
	Forfeited Shares A/c (100 x ₹ 4)	Dr.	400	
	To Equity Share Capital A/c			1,000
	(Being the re-issue of 100 equity shares of ₹ 10 each, @ ₹ 6 per share as fully paid-up as per Board's Resolution No. ... dated ...)			
Dec. 25	Forfeited Shares A/c (₹ 700 – 400)	Dr.	300	
	To Capital Reserve A/c			300
	(Being the profit on re-issue transferred to Capital Reserve)			

2016 (c) Dec. 15	Equity Share Capital A/c (150 x ₹ 10) Dr. Securities Premium A/c (Note 1) Dr. To Equity Share Allotment A/c (150 x ₹ 8) To Equity Share First Call A/c (150 x ₹ 2) To Equity Share Final Call A/c (150 x ₹ 3) To Forfeited Shares A/c (150 x ₹ 2) (Being the forfeiture of 150 equity shares of ₹ 10 each fully called-up for non-payment of allotment and call money as per Board's Resolution No. ... dated ...)	1,500 750	 1,200 300 450 300
Dec. 25	Bank A/c (100 x ₹ 15) Dr. To Equity Share Capital A/c To Securities Premium A/c (Being re-issue of 100 shares of ₹ 10 each @ ₹ 15 each as fully paid-up as per Board's Resolution No. ... dated ...)	1,500	 1,000 500
Dec. 25	Forfeited Shares A/c (Note 2) Dr. To Capital Reserve A/c (Being profit on re-issue transferred to Capital Reserve)	200	 200

Working Notes :

(1) Share premium @ ₹ 5 per share has not been paid by the holder of 150 shares. Therefore, ₹ 750 is to be debited to Securities Premium Account at the time of forfeiture.

(2) Amount forfeited per share is ₹ 2. There is no loss on re-issue. Therefore, ₹ 2 x 100 = ₹ 200 is to be transferred to Capital Reserve and the balance of ₹ 100 will be shown in the Balance Sheet as an addition to Share Capital.

Illustration 11

Mr. Long who was the holder of 200 preference shares of ₹ 100 each, on which ₹ 75 per share has been called up could not pay his dues on Allotment and First call each at ₹ 25 per share. The Directors forfeited the above shares and reissued 150 of such shares to Mr. Short at ₹ 65 per share paid-up as ₹ 75 per share.

Give Journal Entries to record the above forfeiture and re-issue in the books of the company.

Solution **Journal** **Dr.** **Cr.**

Date	Particulars	₹	₹
	Preference Share Capital A/c (200 x ₹ 75) Dr. To Preference Share Allotment A/c To Preference Share First Call A/c To Forfeited Shares A/c (Being the forfeiture of 200 preference shares ₹ 75 each being called up for non-payment of allotment and first call money as per Board's Resolution No. ... dated ...)	15,000	 5,000 5,000 5,000
	Bank A/c (₹ 65 x 150) Dr. Forfeited Shares A/c (₹ 10 x 150) Dr. To Preference Share Capital A/c (Being re-issue of 150 shares at ₹ 65 per share paid-up as ₹ 75 as per Board's Resolution No. ... dated ...)	9,750 1,500	 11,250
	Forfeited Shares A/c Dr. To Capital Reserve A/c (Note 1) (Being profit on re-issue transferred to Capital Reserve)	2,250	 2,250

Working Note : (1) Calculation of amount to be transferred to Capital Reserve

Forfeited amount per share =₹ 5,000 / 200 = ₹ 25
Loss on re-issue = ₹ 75 – ₹ 65 = ₹ 10
Surplus per share re-issued ₹ 15
Transferred to capital Reserve ₹ 15 x 150 = ₹ 2,250. ₹ 25 x 50 = ₹ 1,250 should be shown as an addition to share capital.

Illustration 12

X Co. Ltd invited applications for 10,000 shares of ₹ 10 each payable as : on application ₹ 2; on allotment ₹ 3; on first call ₹ 3 and on final call ₹ 2. Applications were received on all the shares and all of these were accepted. All moneys due were received except the final call money on 100 shares which were forfeited. All the forfeited shares were re-issued to Mr. A @ ₹ 9 each full paid up. Show the Journal and Cash Book entries in the books of X Co Ltd

Solution **In the books of X Co. Ltd**

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
	Share Application A/c Dr. To Share Capital A/c (Being application money on 10,000 shares @ ₹ 2 each transferred to Share Capital Account as per Board's Resolution No. ... dated ...)	20,000	 20,000

	Share Allotment A/c Dr. To Share Capital A/c (Being allotment money due on 10,000 shares @ ₹ 3 each as per Board's Resolution No. ... dated ...)	30,000	30,000
	Share First Call A/c Dr. To Share Capital A/c (Being first call money due on 10,000 shares @ ₹ 3 each as per Board's Resolution No. ... dated ...)	30,000	30,000
	Share Final Call A/c Dr. To Share Capital A/c (Being final call money due on 10,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)	20,000	20,000
	Share Capital A/c (100 x ₹ 10) Dr. To Share Final Call A/c To Forfeited Shares A/c (Being forfeiture of 100 shares of ₹ 10 each for non-payment of final call money as per Board's Resolution No. ... dated ...)	1,000	200 800
	Forfeited Shares A/c Dr. To Share Capital A/c (Being the re-issue of 100 shares of ₹ 10 each @ ₹ 9 as per Board's Resolution No. ... dated ...)	100	100
	Forfeited Shares A/c Dr. To Capital Reserve A/c (Being profit on re-issue transferred to Capital Reserve)	700	700

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c (Being application money received on 10,000 shares @ ₹ 2 per share)	20,000		By Balance c/d	1,00,700
	To Share Allotment A/c (Being allotment money received on 10,000 shares @ ₹ 3 each)	30,000			
	To Share First Call A/c (Being First Call money received on 10,000 shares @ ₹ 3 each)	30,000			
	To Share Final Call A/c (Being Final Call money received on 9,900 shares @ ₹ 2 each)	19,800			
	To Share Capital A/c (Being re-issue of 100 shares @ ₹ 9 each)	900			
		1,00,700			1,00,700

Illustration 13

A Ltd, invited applications for 10,000 shares of ₹ 100 each at a premium of ₹ 10 per share. The amount is payable as follows: On application ₹ 25, on allotment ₹ 35 (including Premium), on first call ₹ 25 and on final call ₹ 25.

The applications were received for 9,000 shares and these were accepted in full. All money due were received except the first and final call money on 200 shares, which were forfeited. Out of these shares, 100 shares were subsequently re-issued @ ₹ 90 per share. You are required to pass Journal entries for recording the above transactions including cash.

Solution

In the books of A Ltd

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c Dr. To Share Application A/c (Being application money on 9,000 shares @ ₹ 25 each received)	2,25,000	2,25,000
	Share Application A/c Dr. To Share Capital A/c (Being application money on 9,000 shares @ ₹ 25 each transferred to Share Capital Account as per Board's Resolution No. ... dated ...)	2,25,000	2,25,000
	Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c (Being allotment money due on 9,000 shares @ ₹ 35 each as per Board's Resolution No. ... dated ...)	3,15,000	2,25,000 90,000
	Bank A/c Dr. To Share Allotment A/c (Being allotment money received on 9,000 shares @ ₹ 35 each)	3,15,000	3,15,000
	Share First Call A/c Dr. To Share Capital A/c (Being first call money due on 9,000 shares @ ₹ 25 each as per Board's Resolution No. ... dated ...)	2,25,000	2,25,000

Bank A/c	Dr.	2,20,000	
To Share First Call A/c			2,20,000
(Being first call money received on 8,800 shares @ ₹ 25 each)			
Share Final Call A/c	Dr.	2,25,000	
To Share Capital A/c			2,25,000
(Being final call money due on 9,000 shares @ ₹ 25 each as per Board's Resolution No. ... dated ...)			
Bank A/c	Dr.	2,20,000	
To Share Final Call A/c			2,20,000
(Being final call money received on 8,800 shares @ ₹ 25 each)			
Share Capital A/c	Dr.	20,000	
To Share First Call A/c			5,000
To Share Final Call A/c			5,000
To Forfeited Shares A/c			10,000
(Being forfeiture of 200 shares of ₹ 100 each for non-payment of first and final call money as per Board's Resolution No. ... dated ...)			
Bank A/c	Dr.	9,000	
Forfeited Shares A/c	Dr.	1,000	
To Share Capital A/c			10,000
(Being re-issue of 100 shares of ₹ 100 each @ ₹ 90 each as fully paid-up as per Board's Resolution No. ... dated ...)			
Forfeited Shares A/c	Dr.	4,000	
To Capital Reserve A/c			4,000
(Being profit on re-issue transferred to Capital Reserve Account)			

Tutorial Note : Here, securities premium on the forfeited shares has already been realized, so securities premium should not be debited at the time of forfeiture of shares.

Working Note : (1) Calculation of Amount to be Transferred to Capital Reserve

Amount forfeited per share = ₹ 10,000 / 200 = ₹ 50; Less: Loss per share = ₹ 10; Surplus per share ₹ 40; Amount to be transferred = 100 x ₹ 40 = ₹ 4,000 and ₹ 50 x 100 = ₹ 5,000 should be shown as an addition to share capital.

Illustration 14

X Limited made an issue of 10,000 Equity Shares of ₹ 15 each payable as follows :

(i) ₹ 4 per share on application;

(ii) ₹ 7 per share (including ₹ 2 per share as premium) on allotment; and

(iii) ₹ 6 per share on first and final call.

Das holding 50 shares failed to pay the allotment and call monies. Pal holding 80 shares failed to pay the call money. All these shares were forfeited and subsequently re-issued to Roy as fully paid-up @ ₹ 7 per share.

Pass Journal Entries (including cash transactions) to record the above issue, forfeiture and re-issue of shares in the books of the company.

Solution

In the books of X Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	40,000	
	To Equity Share Application A/c			40,000
	(Being the application money received on 10,000 shares @ ₹ 4 per share)			
	Equity Share Application A/c	Dr.	40,000	
	To Equity Share Capital A/c			40,000
	(Being application money on 10,000 shares @ ₹ 4 per share transferred to Equity Share Capital Account as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	70,000	
	To Equity Share Capital A/c			50,000
	To Securities Premium A/c			20,000
	(Being allotment money due on 10,000 shares @ ₹ 7 each including premium as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	69,650	
	To Equity Share Allotment A/c			69,650
	(Being receipt of allotment money on 9,950 shares @ ₹ 7 each)			
	Equity Share First and Final Call A/c	Dr.	60,000	
	To Equity Share Capital A/c			60,000
	(Being first and final call money due on 10,000 shares @ ₹ 6 per share as per Board's Resolution No. .. dtd ...)			
	Bank A/c	Dr.	59,220	
	To Equity Share First and Final Call A/c			59,220
	(Being the first and final call money received for 9,870 shares @ ₹ 6 each)			
	Equity Share Capital A/c (130 x ₹ 15)	Dr.	1,950	
	Securities Premium A/c (50 x ₹ 2)	Dr.	100	
	To Equity Share Allotment A/c (50 x ₹ 7)			350

	To Equity Share First and Final Call A/c (130 x ₹ 6)		780
	To Forfeited Shares A/c (₹ 200 + ₹ 720)		920
	(Being the forfeiture of 130 shares for non-payment of allotment, first and final call money as per Board's Resolution No. ... dated ...)		
	Bank A/c (130 x ₹ 12) Dr.	1,560	
	Forfeited Shares A/c (130 x ₹ 3) Dr.	390	
	To Equity Share Capital A/c		1,950
	(Being re-issue of 130 shares of ₹ 15 each @ ₹ 12 per share as per Board's Resolution No. ... dated ...)		
	Forfeited Shares A/c : ₹ (920 – 390) Dr.	530	
	To Capital Reserve A/c		530
	(Being the profit on re-issue transferred to Capital Reserve Account)		

Tutorial Note : Share premium has not been received on 50 shares. At the time of forfeiture, Securities Premium Account will be debited by ₹ 100.

Illustration 15

Beautiful Co. Ltd issued 3,000 equity shares of ₹ 10 each payable as ₹ 3 per share on Application, ₹ 5 per share (including ₹ 2 as premium) on Allotment and ₹ 4 per share on Call. All the shares were subscribed. Money due on all shares was fully received excepting Ram, holding 50 shares, failed to pay the Allotment and Call money and Shyam, holding 100 shares, failed to pay the Call Money. All those 150 shares were forfeited. Of the shares forfeited, 125 shares (including whole of Ram's shares) were subsequently re-issued to Jadu as fully paid up at a discount of ₹ 2 per share.

Pass the necessary entries in the Journal of the company to record the forfeiture and re-issue of the share. Also prepare the Balance Sheet of the company as per Schedule III to the Companies Act, 2013.

Solution

In the books of Beautiful Co. Ltd

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Equity Share Capital A/c (150 x ₹ 10) Dr.	1,500	
	Securities Premium A/c (50 x ₹ 2) Dr.	100	
	To Equity Share Allotment A/c (50 x ₹ 5)		250
	To Equity Share Call A/c (150 x ₹ 4)		600
	To Forfeited Shares A/c		750
	(Being forfeiture of 150 equity shares for non-payment of allotment and call money on 50 shares and for non-payment of call money on 100 shares as per Board's Resolution No. ... dated ...)		
	Bank A/c Dr.	1,000	
	Forfeited Shares A/c Dr.	250	
	To Equity Share Capital A/c		1,250
	(Being re-issue of 125 shares @ ₹ 8 each as per Board's Resolution No. ... dated ...)		
	Forfeited Shares A/c Dr.	350	
	To Capital Reserve A/c		350
	(Being profit on re-issue transferred to Capital Reserve)		

Balance Sheet of Beautiful Co. Ltd. as at ...,

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	29,900
(b) Reserves and Surplus	(2)	6,250
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		36,150

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		36,150
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		36,150

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued Capital :	
3,000 Equity Shares of ₹ 10 each	30,000
Subscribed Capital :	
Subscribed and Fully Paid	
2,975 Equity Shares of ₹ 10 each	29,750
Add: Forfeited Shares	150
	29,900

(2) Reserve and Surplus

Particulars	₹
Securities Premium	5,900
Capital Reserve	350
	6,250

Working Note : (1) Calculation of Amount to be Transferred to Capital Reserve

Amount forfeited per share of Ram	₹ 3	Amount forfeited per share of Shyam	₹ 6
Less: Loss on re-issue per share	₹ 2	Less: Loss on re-issue per share	₹ 2
Surplus	₹ 1	Surplus	₹ 4

Transferred to Capital Reserve : Ram's share (50 x ₹ 1) = ₹ 50; Shyam's share (75 x ₹ 4) = 300. **Total ₹ 350**.

Illustration 16

A holds 200 shares of ₹ 10 each on which he has paid ₹ 2 as application money. B holds 400 shares of ₹ 10 each on which he has paid ₹ 2 per share as application money and ₹ 3 per share as allotment money. C holds 300 shares of ₹ 10 each and has paid ₹ 2 on application, ₹ 3 on allotment and ₹ 3 for the first call. They all fail to pay their arrears on the second and final call of ₹ 2 per share and the directors, therefore, forfeited their shares. The shares are re-issued subsequently for ₹ 12 per share fully paid-up. Journalise the transactions relating to the forfeiture and re-issue.

Solution **Journal**

Date	Particulars		Dr. ₹	Cr. ₹
	Share Capital A/c (900 x ₹ 10)	Dr.	9,000	
	To Share Allotment A/c			600
	To Share First Call A/c			1,800
	To Share Final Call A/c			1,800
	To Forfeited Shares A/c			4,800
	(Being forfeiture of 900 shares of ₹ 10 each for non-payment of allotment, first and final call money as per Board's Resolution No. ... dated ...)			
	Bank A/c (900 x ₹ 12)	Dr.	10,800	
	To Share Capital A/c			9,000
	To Securities Premium A/c			1,800
	(Being the re-issue of 900 shares of ₹ 10 each @ ₹ 12 as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c	Dr.	4,800	
	To Capital Reserve A/c			4,800
	(Being profit on re-issue transferred to Capital Reserve)			

Workings Note : Calculation of Money Received and Not Received

Shareholders	Money Received On				Money Not Received On		
	Application	Allotment	First Call	Final Call	Allotment	First Call	Final Call
A	200	—	—	—	200	200	200
B	400	400	—	—	—	400	400
C	300	300	300	—	—	—	300
TOTAL	900	700	300	—	200	600	900
Money ₹ceivable	₹ 2	₹ 3	₹ 3	₹ 2	₹ 3	₹ 3	₹ 2
	₹ 1,800	₹ 2,100	₹ 900	—	₹ 600	₹ 1,800	₹ 1,800

Illustration 17

A Ltd authorized with ₹ 2,50,000 capital divided into 25,000 shares of ₹ 10 each, issued 20,000 shares payable at ₹ 3 on application, ₹ 5 on allotment (including ₹ 2 as premium) and ₹ 2 on each of two calls. All the 20,000 shares were subscribed. Holders of 1,000 shares failed to pay the allotment money and further on 500 shares there were arrears of first call. All these shares were declared forfeited. Then the second call was made. This was not paid on 200 shares. These shares were also forfeited. All the shares on which only application money was paid and half of the shares on which there was default of first call money were re-issued at ₹ 9 each as fully paid shares. Pass Journal Entries in respect of the above transactions.

Solution

In the books of A Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	60,000	
	To Share Application A/c			60,000
	(Being application money received on 20,000 shares @ ₹ 3 each)			
	Share Application A/c	Dr.	60,000	
	To Share Capital A/c			60,000
	(Being application money on 20,000 shares @ ₹ 3 each transferred to Share Capital Account as per Board's Resolution No. ... dated ...)			
	Share Allotment A/c	Dr.	1,00,000	
	To Share Capital A/c			60,000
	To Securities Premium A/c			40,000
	(Being allotment money due on 20,000 shares @ ₹ 5 each including ₹ 2 premium as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	95,000	
	To Share Allotment A/c			95,000
	(Being allotment money received on 19,000 shares @ ₹ 5 each)			
	Share First Call A/c	Dr.	40,000	
	To Share Capital A/c			40,000
	(Being first call money due on 20,000 @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	37,000	
	To Share First Call A/c			37,000
	(Being first call money received on 18,500 shares @ ₹ 2 each)			
	Share Capital A/c (1,500 x ₹ 8)	Dr.	12,000	
	Securities Premium A/c (1,000 x ₹ 2)	Dr.	2,000	
	To Share Allotment A/c			5,000
	To Share First Call A/c			3,000
	To Forfeited Shares A/c			6,000
	(Being forfeiture of 1,500 shares of ₹ 10 each, ₹ 8 being called up, for non-payment of allotment and first call money as per Board's Resolution No. ... dated ...)			
	Share Second Call A/c	Dr.	37,000	
	To Share Capital A/c			37,000
	(Being second call money due on 18,500 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	36,600	
	To Share Second Call A/c			36,600
	(Being second call money received on 18,300 shares @ ₹ 2 each)			
	Share Capital A/c (200 x ₹ 10)	Dr.	2,000	
	To Share Second Call A/c			400
	To Forfeited Shares A/c			1,600
	(Being forfeiture of 200 shares of ₹ 10 each fully called up for non-payment of second and final call money of ₹ 2 each as per Board's Resolution No. ... dated ...)			

	Particulars		Dr. ₹	Cr. ₹
	Bank A/c (1,250 x ₹ 9)	Dr.	11,250	
	Forfeited Shares A/c (1,250 x ₹ 1)	Dr.	1,250	
	To Share Capital A/c			12,500
	(Being re-issue of 1,250 shares @ ₹ 9 each as fully paid-up as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c	Dr.	3,250	
	To Capital Reserve A/c			3,250
	(Being profit on re-issue of 1,250 shares transferred to Capital Reserve A/c)			

Working Note : (1) Calculation of Amount to be Transferred to Capital Reserve

(a) Amount forfeited per share on which only **application** money was paid ₹ 3
Less: Loss on re-issue ₹ 1
Surplus on re-issue ₹ 2
Amount to be transferred ₹ 2 x 1,000 = ₹ 2,000.

(b) Amount forfeited per share on which **application and allotment** money was paid ₹ 6
Less: Loss on re-issue ₹ 1
Surplus on re-issue ₹ 5
Amount to be transferred =5 x 250 = ₹ 1,250. **Therefore, total amount to be transferred to capital reserve =₹ 2,000 +₹ 1,250 = ₹ 3,250.**

Tutorial Notes (i) At the time of forfeiture of shares, the Share Capital Account will be debited only with called up value. Here, called-up value is ₹ 8 (₹ 3 for application + ₹ 3 for allotment + ₹ 2 for 1st call).

(ii) Securities premium has not been received on 1,000 shares, so the Securities Premium Account will be debited with (1,000 x ₹ 2) = ₹ 2,000. It should be noted that securities premium, once received, cannot be transferred to Forfeited Shares Account.

Illustration 18

Dynamic Ltd makes an issue of 5,000 equity shares of ₹ 100 each at a premium of ₹ 12.50 per share payable as follows: (1) ₹ 12.50 on Application. (2) ₹ 25 on Allotment including premium. (3) ₹ 50 on First call. (4) ₹ 15 on Second call, and (5) ₹ 10 on Final call.

The Application and Allotment moneys are duly received and in addition, holders of 2,500 shares pay in full on allotment. Holders of 100 shares fail to pay the First call and after due notice, their shares are forfeited. The amounts payable on the Second call (made after the forfeiture) are paid in full except that a holder of 50 shares fails to pay. 75 of the 100 shares forfeited are re-issued, credited with ₹ 90 paid for ₹ 65 per share. The new holder pays for these shares in full. The balance of ₹ 10 per share being treated as call-in-advance. The final call is met in full including the arrears of the Second Call. Show the necessary Journal Entries including cash in the Books of Dynamic Ltd

Solution

In the books of Dynamic Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	62,500	
	To Equity Share Application A/c			62,500
	(Being application money received on 5,000 shares @ ₹ 12.50 each)			
	Equity Share Application A/c	Dr.	62,500	
	To Equity Share Capital A/c			62,500
	(Being application money on 5,000 shares @ ₹ 12.50 each transferred to Share Capital Account as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	1,25,000	
	To Equity Share Capital A/c			62,500
	To Securities Premium A/c			62,500
	(Being allotment money due on 5,000 shares @ ₹ 25 each including premium of ₹ 12.50 as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	1,87,500	
	To Calls-in-Advance A/c			1,87,500
	(Being first second and final call money on 2,500 shares received in advance)			
	Bank A/c	Dr.	1,25,000	
	To Equity Share Allotment A/c			1,25,000
	(Being allotment money received on 5,000 shares @ ₹ 25 each)			
	Equity Share First Call A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being first call money due on 5,000 shares @ ₹ 50 each as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	1,20,000	
	To Equity Share First Call A/c			1,20,000
	(Being first call money received on 2,400 shares @ ₹ 50 each)			
	Calls-in-Advance A/c	Dr.	1,25,000	
	To Equity Share First Call A/c			1,25,000
	(Being the adjustment of calls in advance for 2,500 shares @ ₹ 50 each)			

Equity Share Capital A/c (100 x ₹ 75) To Equity Share First Call A/c To Forfeited Shares A/c (Being forfeiture of 100 shares of ₹ 100 each ₹ 75 being called up for non-payment of first call money @ ₹ 50 each as per Board's Resolution No. ... dated ...)	Dr.	7,500	 5,000 2,500
Equity Share Second Call A/c To Equity Share Capital A/c (Being second call money due on 4,900 shares @ ₹ 15 each as per Board's Resolution No. ... dated ...)	Dr.	73,500	 73,500
Bank A/c To Equity Share Second Call A/c (Being second call money received on 2,350 shares @ ₹ 15 each)	Dr.	35,250	 35,250
Calls-in-Advance A/c To Equity Share Second Call A/c (Being the adjustment of calls-in-advance for 2,500 shares @ ₹ 15 per share)	Dr.	37,500	 37,500
Bank A/c (75 x ₹ 65) Forfeited Shares A/c (75 x ₹ 25) To Equity Share Capital A/c (75 x ₹ 90) (Being re-issue of 75 shares of ₹ 100 each @ ₹ 65 per share, ₹ 90 being called up as per Board's Resolution No. ... dated ...)	Dr. Dr.	4,875 1,875	 6,750
Bank A/c To Calls-in-Advance A/c (Being the amount received in advance from the new shareholders of 75 shares @ ₹ 10 each in respect of final call)	Dr.	750	 750
Equity Share Final Call A/c To Equity Share Capital A/c (Being share final call money due on 4,975 shares @ ₹ 10 each as per Board's Resolution No. ... dated ...)	Dr.	49,750	 49,750
Bank A/c To Equity Share Final Call A/c (Being final call money received on 2,400 shares @ ₹ 10 each)	Dr.	24,000	 24,000
Calls-in-Advance A/c To Equity Share Final Call A/c (Being the adjustment of calls-in-advance in respect of final call on 2,575 shares @ ₹ 10 each)	Dr.	25,750	 25,750
Bank A/c To Equity Share Second Call A/c (Being second call money received on 50 shares @ ₹ 15 each)	Dr.	750	 750

Issue of Shares for "Consideration other than Cash "

Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. Shares may also be issued in payment for services rendered by promoters, lawyers in the formation of the company. In the Balance Sheet, these shares should be shown separately.

Within one month of allotment, the company must produce before the Registrar a written contract of sale of service in respect of which shares have been allotted.

Accounting Entries for Purchase of Assets

(a) When assets are purchased in exchange of shares

Assets Account Dr.
  To Vendor's Account

(b) When shares are issued to vendor at par

Vendor Account Dr.
  To Share Capital Account

(c) When shares are issued to vendor at a premium

Vendor Account Dr.
  To Share Capital Account
  To Securities Premium Account

Accounting Entries for Issue of Shares to Promoters, Lawyers at Free of Cost

Goodwill Account Dr.
  To Share Capital Account

Illustration 19

X Co. Ltd was incorporated with an authorised share capital of 1,00,000 equity shares of ₹ 10 each. The directors decided to allot 10,000 shares credited as fully paid to the promoters for their services. The company also purchased land and buildings from Y Co. Ltd for ₹ 4,00,000 payable in fully paid-up shares of the company. The balance of the shares were issued to the public, which were fully subscribed and paid for. You are required to pass Journal entries and to prepare the Balance Sheet as per Schedule III to the Companies Act, 2013.

Solution **Journal** **Dr.** **Cr.**

Date	Particulars		₹	₹
	Goodwill A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Being the issue of 10,000 shares of ₹ 10 each fully paid to the promoters for their services as per Board's Resolution No. ... dated ...)			
	Land and Buildings A/c	Dr.	4,00,000	
	To Y Co. Ltd A/c			4,00,000
	(Being the land and buildings purchased from Y Co. Ltd as per agreement dated ...)			
	Y Co. Ltd A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being the issue of 40,000 shares of ₹ 10 each to Y Co. Ltd against purchase of land and buildings as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			5,00,000
	(Being the issue of 50,000 shares of ₹ 10 each as per Board's Resolution No. ... dated ...)			

Balance Sheet of X Ltd. as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		—
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		10,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets (Land and Building)		4,00,000
(ii) Intangible Assets (Goodwill)		1,00,000
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		5,00,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		10,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital : 1,00,000 Equity Shares of ₹ 10 each	10,00,000
Issued, Subscribed and Paid-up Capital : 1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000
(Of the above, 50,000 shares have been allotted for consideration other than cash)	

Illustration 20

MK Co. Ltd. was formed with an authorised capital of ₹ 10,00,000 divided into 10,000 equity shares of ₹ 100 each. It issued equity shares as given below :

(a) 100 shares were issued to promoters for services rendered by them;

(b) 900 shares were issued to the vendor for purchase of machinery; and

(c) 9,000 shares were offered to public for subscription payable as follows :

on application	₹ 40
on allotment	40 (including premium)
on first call	20
on final call	20

Issue was fully subscribed and full allotment was made to all the applicants. Arrear of instalments were as under : On allotment 250 shares; on first call 750 shares; and on final call 2,000 shares.

Company decided to forfeit shares on which less than ₹ 80 per share had been paid on account of share capital.

Pass journal entries in the books of the company.

Solution

In the books of M K Co. Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Goodwill A/c	Dr.	10,000	
	To Equity Share Capital A/c			10,000
	(Being the issue of 100 equity shares of ₹ 100 each at par to promoters for services rendered by them as per Board's Resolution No. ... dated ...)			
	Machinery A/c	Dr.	90,000	
	To Equity Share Capital A/c			90,000
	(Being issue of 900 equity shares of ₹ 100 each at par to vendor for purchase of machinery as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	3,60,000	
	To Equity Share Application A/c			3,60,000
	(Being application money received for 9,000 shares @ ₹ 40 each)			
	Equity Share Application A/c	Dr.	3,60,000	
	To Equity Share Capital A/c			3,60,000
	(Being the allotment of 9,000 equity shares as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	3,60,000	
	To Equity Share Capital A/c			1,80,000
	To Securities Premium A/c			1,80,000
	(Being allotment of money due on 9,000 equity shares @ ₹ 40 each including ₹ 20 premium as per Board's Resolution No. ... dated ...)			
	Bank A/c [8,750 x ₹ 40]	Dr.	3,50,000	
	Calls-in-Arrear A/c [250 x ₹ 40]	Dr.	10,000	
	To Equity Share Allotment A/c			3,60,000
	(Being allotment money received for 8,750 equity shares @ ₹ 40 each including premium. Allotment money due on 250 shares @ ₹ 40 transferred to Calls-in-Arrear Account)			
	Equity Share First Call A/c	Dr.	1,80,000	
	To Equity Share Capital A/c			1,80,000
	(Being first call money due on 9,000 equity shares @ ₹ 20 each as per Board's Resolution No. ... dated ...)			
	Bank A/c [8,250 x ₹ 20]	Dr.	1,65,000	
	Calls-in-Arrear A/c [750 x ₹ 20)		15,000	
	To Eqity Share First Call A/c			1,80,000
	(Being first call money received for 8,250 equity shares @ ₹ 20 each. First call money on 750 shares not paid has been transferred to Calls-in-Arrear Account)			

Equity Share Final Call A/c To Equity Share Capital A/c (Being final call money due on 9,000 equity shares @ ₹ 20 each as per Board's Resolution No. ... dated ...)	Dr.	1,80,000	 1,80,000
Bank A/c [7,000 x ₹ 20] Calls-in-Arrear A/c [2,000 x ₹ 20] To Equity Share Final Call A/c (Being final call money received on 7,000 equity shares @ ₹ 20. Final call money not paid on 2,000 shares has been transferred to Calls-in-Arrear Account)	Dr.	1,40,000 40,000	 1,80,000
Equity Share Capital A/c [750 x ₹ 100] (Note 1) Securities Premium A/c (250 x ₹ 20) To Calls-in-Arrear A/c (Note 2) To Forfeited Shares A/c (Note 3) (Being the forfeiture of 750 equity shares for non-payment of allotment money on 250 shares, first call money money on 750 shares as per Board's Resolution No. ... dated ...)	Dr. Dr.	75,000 5,000	 40,000 40,000

Working Notes :

(1) Final call money has not been paid for 2,000 shares. Out of these 2,000 shares, only final call has not been paid for 1,250 shares (2,000 – 750). This 1,250 shares will not be forfeited. Only 750 equity shares are to be forfeited and the break-up is as follows :
On 250 shares only application money @ ₹ 20 has been paid
On 500 shares application and allotment @ ₹ 40 has been paid.

(2) Calculation of Calls-in-Arrear :

250 × (₹ 40 allotment + ₹ 20 first call + ₹ 20 final call)	20,000
500 × (₹ 20 first call + ₹ 20 final call)	20,000
	40,000

(3) Calculation of Amount Forfeited :

200 × (₹ 40 application money)	10,000
500 × (₹ 40 application + ₹ 20 allotment)	30,000
	40,000

Over subscription and Pro-rata Allotment

Over subscription is the application money received for more than the number of shares offered to the public by a company. It usually occurs in the case of good issues and depends on many other factors like investors' confidence in the company, general economic conditions, pricing of the issue etc. As per SEBI (ICDR) Regulations, 2009, no allotment shall be made by the issuer ***in excess of the specified securities offered through offer document***. When the shares are oversubscribed, the company cannot satisfy all the applicants. It means that a decision has to be made on how the shares are going to be allotted. Shares can be allotted to the applicants by a company in any manner it thinks proper. The company may reject some applicants in full, i.e., no shares are allotted to some applicants and application money is refunded. Usually, multiple applications by the same persons are not considered. Allotment may be given to the rest of the applicants in full, i.e., for the number of shares they have applied for. A third alternative is that a company may allot shares to the applicants on ***pro-rata*** basis. 'Pro-rata allotment' means allotment in proportion of shares applied for.

For example, a company offers to the public 10,000 shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis, applicants for 12,000 shares are to be allotted 10,000 shares, i.e., on the 12,000 : 10,000 or 6 : 5 ratio. Any applicant who has applied for 6 shares will be allotted 5 shares.

Under pro-rata allotment, the excess application money received is adjusted against the amount due on allotment or calls. Surplus money after making adjustment against future calls is returned to the applicants. The applicants are informed about the allotment procedure through an advertisement in leading newspapers.

There is no separate journal entry for forfeiture of shares when there is a pro-rata allotment. But it requires to calculate the net amount due on allotment or any other call, and also the total amount forfeited. When there is a pro-rata allotment, the total application money paid by an applicant is more than the exact amount due on application. The excess amount is treated as an advance against allotment or any other future calls. The net amount due on allotment or any other calls is the difference between the amount due on allotment or any other calls and the excess amount received in application.

Accounting Entries:

(a) For rejected application:

Share Application Account Dr.

To Bank Account

(b) For pro-rata allotment

Share Application Account Dr.

To Share Allotment Account

(Being excess application money adjusted against allotment money as per Board's Resolution No ... dated ...)

Illustration 21

A public limited company invited applications for the issue of 2,00,000 Equity Shares of ₹ 10 each at a premium of ₹ 1 per share. The shares were payable as : ₹ 2 on application; ₹ 4 on allotment (including premium); ₹ 3 on first call; ₹ 2 on final call. The applications were received for 2,60,000 shares. The company decided to reject 40,000 share applications and were allotted the rest proportionately. All the calls were made and an applicant holding 6,000 shares could not pay the dues on final call. Consequently, these share were forfeited and subsequently re-issued @ ₹ 9 per share.

Show the Journal Entries and Cash Book of the company.

Solution **In the books of the Company**

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being the application money on 2,00,000 shares @ ₹ 2 per share transferred to Equity Share Capital Account as per Board's Resolution No. . . . dated . . .)	4,00,000	 4,00,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being allotment money due on 2,00,000 shares @ ₹ 4 each incl. premium as per Board's Res. No. ... dt ...)	8,00,000	 6,00,000 2,00,000
	Equity Share Application A/c Dr. To Equity Share Allotment A/c (Being adjustment of surplus application money on 20,000 shares)	40,000	 40,000
	Equity Share First Call A/c Dr. To Equity Share Capital A/c (Being first call money due on 2,00,000 shares @ ₹ 3 each as per Board's Resolution No. . . . dated . . .)	6,00,000	 6,00,000
	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being final call money due on 2,00,000 shares @ ₹ 2 per share as per Board's Resolution No. ... dated ...)	4,00,000	 4,00,000
	Equity Share Capital A/c (6,000 x ₹ 10) Dr. To Equity Share Final Call A/c To Forfeited Shares A/c (Being the forfeiture of 6,000 shares for non-payment of final call money as per Board's Resolution No. ... dated ...)	60,000	 12,000 48,000
	Forfeited Shares A/c (6,000 x ₹ 1) Dr. To Equity Share Capital A/c (Being the loss on re-issue of 6,000 shares)	6,000	 6,000
	Forfeited Shares A/c (₹ 48,000 – 6,000) Dr. To Capital Reserve A/c (Being the profit on re-issue transferred to Capital Reserve Account)	42,000	 42,000

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being the application money received on 2,60,000 shares @ ₹ 2 each)	5,20,000		By Equity Share Application A/c (Being excess money refunded on 40,000 shares @ ₹ 2 each as per Board Resolution No... dated ...)	80,000
	To Equity Share Allotment A/c (Being allotment money received after adjustment of excess application money)	7,60,000		By Balance c/d	22,42,000
	To Equity Share First Call A/c (Being first call money received on 2,00,000 shares @ ₹ 3 each)	6,00,000			
	To Equity Share Final Call A/c (Being final call money received on 1,94,000 shares @ ₹ 2 each)	3,88,000			

	To Equity Share Capital A/c (Being money received on re-issue of 6,000 shares @ ₹ 9 each)	54,000			
		23,22,000			23,22,000

Illustration 22

Pioneer Construction Company Ltd issued for public subscription 20,000 Equity Shares of ₹ 10 each at par payable ₹ 2 per share on Application, ₹ 3 per share on Allotment and the balance in two calls of equal amount. Applications were received for 30,000 shares. The shares were allotted pro-rata to the applicants for 24,000 shares, the remaining applications being rejected. Money overpaid on application was utilized towards sums due on allotment.

All money due were received except that a shareholder named Bimal to whom 1,000 shares were allotted failed to pay both the calls. These shares were forfeited and subsequently re-issued to Parimal at ₹ 11 per share as fully paid-up.

Show the Journal Entires (including cash transactions) in the books of the company and also draw up the Balance Sheet as per ***Schedule III to the Companies Act, 2013***.

Solution **In the books of Pioneer Construction Co. Ltd**

Journal **Dr.** **Cr.**

Date	Particulars		₹	₹
	Bank A/c To Equity Share Application A/c (Being application money received on 30,000 shares @ ₹ 2 each)	Dr.	60,000	60,000
	Equity Share Application A/c To Bank A/c (Being application money of 6,000 shares were refunded as per Board's Resolution No. ... dated ...)	Dr.	12,000	12,000
	Equity Share Application A/c To Equity Share Capital A/c (Being application money on 20,000 sh. @ ₹ 2 trans. to Sh. Capital A/c as per Board's Resolution No. ... dated ...)	Dr.	40,000	40,000
	Equity Share Application A/c To Equity Share Allotment A/c (Being excess application money on 4,000 shares @ ₹ 2 each transferred to Share Allotment Account as per Board's Resolution No. ... dated ...)	Dr.	8,000	8,000
	Equity Share Allotment A/c To Equity Share Capital A/c (Being allotment money due on 20,000 shares @ ₹ 3 each as per Board's Resolution No. ... dated ...)	Dr.	60,000	60,000
	Bank A/c To Equity Share Allotment A/c (Being allotment money received on 20,000 shares @ ₹ 3 each after adjusting ₹ 8,000)	Dr.	52,000	52,000
	Equity Share First Call A/c To Equity Share Capital A/c (Being first call money due on 20,000 shares @ ₹ 2.50 as per Board's Resolution No. ... dated ...)	Dr.	50,000	50,000
	Bank A/c To Equity Share First Call A/c (Being first call money received on 19,000 shares @ ₹ 2.50)	Dr.	47,500	47,500
	Equity Share Final Call A/c To Equity Share Capital A/c (Being final call money due on 20,000 shares @ ₹ 2.50 each as per Board's Resolution No. ... dated ...)	Dr.	50,000	50,000
	Bank A/c To Equity Share Final Call A/c (Being final call money received on 19,000 shares @ ₹ 2.50 each)	Dr.	47,500	47,500
	Equity Share Capital A/c (1,000 x ₹ 10) To Equity Share First Call A/c To Equity Share Final Call A/c To Forfeited Shares A/c (Being forfeiture of 1,000 equity sh for non-payment of first & final call money as per Board's Res. No. ... dt ...)	Dr.	10,000	2,500 2,500 5,000
	Bank A/c (1,000 x ₹ 11) To Equity Share Capital A/c To Securities Premium A/c (Being the re-issue of 1,000 sh. of ₹ 10 each @ ₹ 11 per share as fully paid as per Board's Resolution No. ... dated ...)	Dr.	11,000	10,000 1,000
	Forfeited Shares A/c To Capital Reserve A/c (Being profit on reissue transferred to Capital Reserve)	Dr.	5,000	5,000

Balance Sheet of Pioneer Construction Limited as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus	(2)	6,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		2,06,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		2,06,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		2,06,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	1,000
Capital Reserve	5,000
	6,000

Illustration 23

The Fancy Co. Ltd issued 4,000 equity shares of ₹ 10 each at a Premium of ₹ 2 per share payable as follows: On application ₹ 2; On allotment ₹ 6 (including premium);

On first call ₹ 2; On final call ₹ 2. 6,000 shares were applied for and allotment was made pro-rata. Excess application moneys were utilized towards dues on allotment. Mr. B who held 120 shares failed to pay first call and final call and these shares were forfeited. Out of these forfeited shares, 100 forfeited shares were re-issued to Mr. K. as fully paid-up for ₹ 9 per share.

Show the Journal Entries and the Cash Book of the company and also draw up the Balance Sheet as per ***Schedule III to the Companies Act, 2013***.

Solution

In the books of Fancy Co. Ltd

Cash Book (Bank column only)

Dr. Date	Particulars	₹	Date	Particulars	₹ Cr.
	To Equity Share Application A/c (Being application money received on 6,000 shares @ ₹ 2 each)	12,000		By Balance c/d	48,420
	To Equity Share Allotment A/c (Being balance of allotment money received)	20,000			
	To Equity Share First Call A/c (Being first call money received on 3,880 shares @ ₹ 2 each)	7,760			
	To Equity Share Final Call A/c (Being final call money received on 3,880 shares @ ₹ 2 each)	7,760			
	To Equity Share Capital A/c (Being re-issue of 100 shares of ₹ 10 each @ ₹ 9 per share as fully paid up)	900			
		48,420			48,420

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Equity Share Application A/c	Dr.	8,000	
	To Equity Share Capital A/c			8,000
	(Being application money on 4,000 shares @ ₹ 2 each transferred to Share Capital Account as per Board's Resolution No. ... dated ...)			
	Equity Share Application A/c	Dr.	4,000	
	To Equity Share Allotment A/c			4,000
	(Being excess application money on 2,000 shares transferred to Share Allotment Account after adjustment as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	24,000	
	To Equity Share Capital A/c			16,000
	To Securities Premium A/c			8,000
	(Being allotment money due on 4,000 shares @ ₹ 6 each as per Board's Resolution No. ... dated ...)			
	Equity Share First Call A/c	Dr.	8,000	
	To Equity Share Capital A/c			8,000
	(Being first call money due on 4,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
	Equity Share Final Call A/c	Dr.	8,000	
	To Equity Share Capital A/c			8,000
	(Being final call money due on 4,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
	Equity Share Capital A/c (120 x ₹ 10)	Dr.	1,200	
	To Equity Share First Call A/c			240
	To Equity Share Final Call A/c			240
	To Forfeited Shares A/c			720
	(Being forfeiture of 120 shares of ₹ 10 each for non-payment of first and final call money @ ₹ 2 each as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c (100 x ₹ 1)	Dr.	100	
	To Equity Share Capital A/c			100
	(Being re-issue of 100 shares at a loss of ₹ 1 per share as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c	Dr.	500	
	To Capital Reserve A/c (See note)			500
	(Being profit on re-issue of 100 shares transferred to Capital Reserve)			

Balance Sheet of Fancy Company Limited as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	39,000
(b) Reserves and Surplus	(2)	8,500
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		48420
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		—
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		48,420
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		48,420

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
? Equity Shares of ? each		?
Issued Capital :		
4,000 Equity Shares of ₹ 10 each fully paid		40,000
Subscribed Capital :		
Subscribed and Fully Paid		
3,980 Equity Shares of ₹ 10 each	39,800	
Add : Forfeited Shares	500	39,920

(2) Reserve and Surplus

Particulars	₹
Securities Premium	8,000
Capital Reserve	500
	8,500

Working Note: (1) Calculation of Amount to be Transferred to Capital Reserve

Amount forfeited per share = ₹ 720/120	₹ 6
Less: Loss on re-issue per share	₹ 1
Surplus per share re-issued	₹ 5

Transferred to Capital Reserve ₹ 5 x 100 = ₹ 500 and ₹ 6 x 20 = ₹ 120 to be shown with Share Capital.

Illustration 24

Mandal Limited invited applications for 1,00,000 shares of ₹ 10 each at an issue price of ₹ 12, payable as ₹ 5 (including premium) on application, ₹ 4 on allotment, and the balance by way of first and final call.

Applications for 1,20,000 shares were received. The Board of Directors allotted (i) in full to applicants for 70,000 shares and (ii) the balance of the shares pro rata to the remaining applicants. The board also utilised any excess application money towards the amount due on allotment.

Sunil, to whom 2,100 shares were allotted on a pro rata basis, failed to pay the amounts due from him in respect of allotment and the call. These shares were forfeited and subsequently reissued at ₹ 11 each.

Prepare the following Ledger Accounts in the books of Mandal Limited :

(i) Share Capital Account; (ii) Share Application Account;
(iii) Share Allotment Account; (iv) Share Call Account;
(v) Share Forfeited Account; (vi) Securities Premium Account; and,
(vii) Cash Book.

Solution

In the books of Mandal Limited

Dr. Cash Book (Bank column only) Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c (Being the application money received on 1,20,000 shares @ ₹ 5 each)	6,00,000		By Balance c/d	12,15,400
	To Share Allotment A/c (Note 2) (Being allotment money received on 97,900 shares @ ₹ 4 each after adjustment of excess application money)	2,98,600			
	To Share Call A/c (Being first and final call money received on 97,900 shares @ ₹ 3 each)	2,93,700			
	To Share Capital A/c (Being the re-issue of 2,100 shares of ₹ 10 each)	21,000			
	To Securities Premium A/c (Being the premium received on 2,100 shares @ ₹ 1 each)	2,100			
		12,15,400			12,15,400

Dr. Share Capital Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Shares Allotment A/c	1,400		By Shares Application A/c	3,00,000
	To Shares Call A/c	6,300		By Shares Allotment A/c	4,00,000
	To Forfeited Shares A/c (Note 3)	13,300		By Shares Call A/c	3,00,000
	To Balance c/d	10,00,000		By Bank A/c	21,000
		10,21,000			10,21,000

Dr. Share Application Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	3,00,000		By Bank A/c	6,00,000
	To Securities Premium A/c	2,00,000			
	To Share Allotment A/c (Excess money)	1,00,000			
		6,00,000			6,00,000

Dr. Share Allotment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	4,00,000		By Share Application A/c	1,00,000
				By Bank A/c (Note 2)	2,98,600
				By Share Capital A/c	1,400
		4,00,000			4,00,000

Dr. Share Call Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	3,00,000		By Bank A/c	2,93,700
				By Share Capital A/c	6,300
		3,00,000			3,00,000

Dr. Share Forfeited Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Capital Reserve A/c	13,300		By Share Capital A/c (Note 3)	13,300

Dr. Securities Premium Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	2,02,100		By Share Application A/c	2,00,000
				By Bank A/c	2,100
		2,02,100			2,02,100

Working Notes :

(1) Amount due on Allotment	₹	**(2) Allotment Money Received**	₹
No. of shares applied for = 50,000 / 30,000 x 2,100	3,500	Amount due on allotment	4,00,000
Application money paid = 3,500 x ₹ 5	17,500	Less: Excess application money	1,00,000
Amount applied in application = 2,100 x ₹ 5	10,500		3,00,000
Excess application money	7,000	Less: Amount not paid by Sunil (Note 1)	1,400
Amount payable on allotment = 2,100 x ₹ 4	8,400		2,98,600
Less: Excess application money	7,000	**(3) Amount Transferred to Shares Forfeited Account**	
Amount not paid by Sunil	1,400	Amount received from Sunil (3,500 x ₹ 5)	17,500
		Less: Amount trans. to Securities Premium A/c (2,100 x ₹ 2)	4,200
			13,300

Illustration 25

Apollo Television Co., Ltd has authorized capital ₹ 4,00,000. The company issues for public 20,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share payable as: ₹ 6 on application (including premium ₹ 3); ₹ 5 on allotment (including premium ₹ 2); and the balance by two calls of equal amount.

Applications are received for 35,000 shares. Dividing the applications into different groups, allotments were made in the following ways:

Group A applying for total 5,000 shares allotted fully.

Group B applying for total 20,000 shares are made pro-rata allotment for 15,000 shares.

Group C applying for total 10,000 shares are refused.

Directors while making allotment adjust the excess amount received on application against allotment money due. When second and final calls were made, shareholders holding 500 shares failed to pay the final call money. The Directors forfeited these shares. All the forfeited shares were re-issued at ₹ 9 per share.

It is agreed that brokerage @ 3% and underwriting commission @ 3% (based on face value) will be paid for this issue. Claims of the brokers and underwriters are satisfied by issuing to them additional equity shares of ₹ 10 each at a premium of ₹ 5 per share (without any cash payment).

Show the Journal entries in the books of the company to record the above transactions and particulars in this respect in the Balance Sheet of the company as per ***Schedule III to the Companies Act, 2013***.

Solution

In the books of Apollo Television Co. Ltd

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c Dr. To Equity Share Application A/c (Being application money on 35,000 shares received @ ₹ 6 per share)	2,10,000	 2,10,000
	Equity Share Application A/c Dr. To Bank A/c (Being application money on 10,000 shares @ ₹ 6 each refunded as per Board's Resolution No. ... dated ...)	60,000	 60,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being application money on 20,000 shares transferred to Equity Share Capital Account and Securities Premium Account as per Board's Resolution No. ... dated ...)	1,20,000	 60,000 60,000
	Equity Share Application A/c Dr. To Equity Share Allotment A/c (Being excess application money on 5,000 shares @ ₹ 6 per share transferred to Share Allotment Account as per Board's Resolution No. ... dated ...)	30,000	 30,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being the amount due on allotment @ ₹ 5 per share including premium of ₹ 2 as per Board's Resolution No. ... dated ...)	1,00,000	 60,000 40,000
	Bank A/c Dr. To Equity Share Allotment A/c (Being balance of the allotment money received)	70,000	 70,000
	Equity Share First Call A/c Dr. To Equity Share Capital A/c (Being the first call money due on 20,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)	40,000	 40,000
	Bank A/c Dr. To Equity Share First Call A/c (Being first call money received on 20,000 shares @ ₹ 2 each)	40,000	 40,000

Equity Share Final Call A/c To Equity Share Capital A/c (Being final call money due on 20,000 shares @ ₹ 2 per share as per Board's Resolution No. ... dated ...)	Dr.	40,000	40,000
Bank A/c To Equity Share Final Call A/c (Being final call money on 19,500 shares @ ₹ 2 per share received)	Dr.	39,000	39,000
Equity Share Capital A/c (500 x ₹ 10) To Equity Share Final Call A/c To Forfeited Share A/c (Being forfeiture of 500 equity shares of ₹ 10 each fully called up for non-payment of final call money as per Board's Resolution No. ... dated ...)	Dr.	5,000	1,000 4,000
Bank A/c (500 x ₹ 9) Forfeited Shares A/c (500 x ₹ 1) To Equity Share Capital A/c (Being re-issue of 500 shares of ₹ 10 each @ ₹ 9 per share as per Board's Resolution No. ... dated ...)	Dr. Dr.	4,500 500	5,000
Forfeited Shares A/c To Capital Reserve A/c (Being profit on re-issue of shares transferred to Capital Reserve)	Dr.	3,500	3,500
Brokerage on issue of shares A/c Commission on issue of shares A/c To Equity Share Capital A/c To Securities Premium A/c (Being 3% brokerage and 3% under-writing commission paid by issuing 800 equity shares of ₹ 10 each at a premium of ₹ 5 per share)	Dr. Dr.	6,000 6,000	8,000 4,000

Balance Sheet of Apollo Television Company Limited as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,08,000
(b) Reserves and Surplus	(2)	95,500
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		3,03,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Long-term Loans and Advances		—
(d) Other Non-current Assets		—
(2) Current Assets :		—
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		3,03,500
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		3,03,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
40,000 Equity Shares of ₹ 10 each	4,00,000
Issued, Subscribed and Paid-up Capital :	
20,800 Equity Shares of ₹ 10 each fully paid	2,08,000
(Out of the above, 800 shares have been issued for consideration other than cash.)	

(6) Other Current Liabilities

Particulars		₹
Securities premium		1,04,000
Capital Reserve		3,500
		1,07,500
Less: Brokerage on issue of Shares*	6,000	
Less: Commission on issue of Shares*	6,000	12,000
		95,500

*As per Schedule III, any miscellaneous expenditure such as commission on issue of shares will not be shown on the assets side of the Balance Sheet. It will be shown under '**Reserve and Surplus**'.

Illustration 26

JHP Limited is a company with an authorised share capital of 10,00,000 in equity shares of ₹ 10 each, of which 6,00,000 shares had been issued and fully paid on 30th June, 2016. The company proposed to make a further issue of 1,00,000 of these ₹ 10 shares at a price of ₹ 14 each, the arrangements for payment being :

(a) ₹ 2 per share payable on application, to be received by 1st July, 2016;

(b) Allotment to be made on 10th July, 2016 and a further ₹ 5 per share (including the premium) to be payable;

(c) The final call for the balance to be made, and the money received by 30th April, 2016.

Applications were received for 3,55,000 shares and were dealt with as follows:

(i) Applicants for 5,000 shares received allotment in full; (ii) Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment; (iii) Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and (iv) The money due on final call was received on the due date.

You are required to record these transactions (including cash items) in the Journal of JHP Limited.

Solution — **Journal of JHP Limited**

Date	Particulars		Dr. ₹	Cr. ₹
2016 July 1	Bank A/c (Note 1 - Column 3)	Dr.	7,10,000	
	To Equity Share Application A/c			7,10,000
	(Being application money received on 3,55,000 shares @ ₹ 2 per share)			
July 10	Equity Share Application A/c	Dr.	7,10,000	
	To Equity Share Capital A/c			2,00,000
	To Equity Share Allotment A/c (Note 1 column 5)			4,30,000
	To Bank A/c (Note 1 - Column 6)			80,000
	(Being application money on 1,00,000 shares transferred to Equity Share Capital Account; on 2,15,000 shares adjusted with allotment and on 40,000 shares refunded as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			1,00,000
	To Securities Premium A/c			4,00,000
	(Being allotment money due on 1,00,000 shares @ ₹ 5 each including premium as per Board's Resolution No. ... dt ...)			
	Bank A/c (Note 1 - Column 8)	Dr.	70,000	
	To Equity Share Allotment A/c			70,000
	(Being balance allotment money received)			
2017 ?	Equity Share Final Call A/c	Dr.	7,00,000	
	To Equity Share Capital A/c			7,00,000
	(Being final call money due on 1,00,000 shares @ ₹ 7 per share as per Board's Resolution No. ... dated ...)			
April 30	Bank A/c	Dr.	7,00,000	
	To Equity Share Final Call A/c			7,00,000
	(Being final call money on 1,00,000 shares @ ₹ 7 each received)			

Working Notes : **(1) Calculation for Adjustment and Refund**

Category	No. of Shares Applied for (1)	No. of Shares Allotted (2)	Amount Received on Application (3)	Amount Required on Application (4)	Amount Adjusted on Allotment (5)	Refund [3 – (4 + 5)] (6)	Amount due on Allotment (7)	Amount Receivable on Allotment [7 – 5] (8)
(i)	5,000	5,000	10,000	10,000	—	Nil	25,000	25,000
(ii)	30,000	15,000	60,000	30,000	30,000	Nil	75,000	45,000
(iii)	3,20,000	80,000	6,40,000	1,60,000	4,00,000	80,000	4,00,000	—
TOTAL	3,55,000	1,00,000	7,10,000	2,00,000	4,30,000	80,000	5,00,000	70,000

Illustration 27

X Co. Ltd issued 40,000 equity shares of ₹ 10 each at a premium of ₹ 2.50 per share. The amount was payable ₹ 2 on application, ₹ 4.50 on allotment (including premium) and ₹ 6 on call. 96,400 shares were applied for and owing to heavy over-subscription, allotment was made as follows:

Applicants for 23,000 shares (in respect of application for 2,000 or more shares) were allotted 10,560 shares. Applicants for 48,000 shares (in respect of application for 1,000 or more shares) were allotted 14,200 shares. Applicants for 25,400 shares were allotted 15,240 shares *pro-rata.*

It was decided that the excess amount received on application would be utilised in payment of allotment money and the surplus, if any, would be refunded. P, to whom 300 shares were allotted on pro-rata basis, failed to pay the allotment money. Q, who was allotted 450 shares also on pro-rata basis, failed to pay the call money. Their shares were consequently forfeited after the call was made.

Pass the necessary Journal Entries to record the above transactions (including cash transactions).

Solution

In the books of X Co. Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c (Note 1 - Column 3)	Dr.	1,92,800	
	To Equity Share Application A/c			1,92,800
	(Being the application money received for 96,400 shares of ₹ 10 each @ ₹ 2 per share)			
	Equity Share Application A/c	Dr.	1,92,800	
	To Equity Share Capital A/c			80,000
	To Equity Share Allotment A/c			1,09,100
	To Bank A/c (Note 1 - Column 6)			3,700
	(Being share application money transferred to Share Capital Account and the excess money adjusted against allotment and the balance refunded as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	1,80,000	
	To Equity Share Capital A/c			80,000
	To Securities Premium A/c			1,00,000
	(Being allotment money due on 40,000 shares @ ₹ 4.50 per share including premium as per Board's Resolution No. ... dated ...)			
	Bank A/c (Note 5)	Dr.	69,950	
	To Equity Share Allotment A/c			69,950
	(Being receipt of allotment money on all shares except for 300 shares)			
	Equity Share Final Call A/c	Dr.	2,40,000	
	To Equity Share Capital A/c			2,40,000
	(Being final call money due on 40,000 shares @ ₹ 6 per share as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	2,35,500	
	To Equity Share Final Call A/c			2,35,500
	(Being share final call money received in full except for 750 shares)			
	Equity Share Capital A/c	Dr.	7,500	
	Securities Premium A/c	Dr.	750	
	To Equity Share Allotment A/c			950
	To Equity Share Final Call A/c			4,500
	To Forfeited Shares A/c			2,800
	(Being forfeiture of 750 shares of ₹ 10 each for non-payment of allotment and call money as per Board's Resolution No. ... dated ...)			

Working Notes : **(1) Calculation for Adjustment and Refund**

Category	No. of Shares Applied for (1)	No. of Shares Allotted (2)	Amount Received on Application (3)	Amount Required on Application (4)	Amount Adjusted on Allotment (5)	Refund [3 – (4 + 5)] (6)	Amount due on Allotment (7)	Amount Receivable on Allotment [7 – 5] (8)
(i)	23,000	10,560	46,000	21,120	24,880	Nil	47,520	22,640
(ii)	48,000	14,200	96,000	28,400	63,900	3,700	63,900	—
(iii)	25,400	15,240	50,800	30,480	20,320	Nil	68,580	48,260
TOTAL	96,400	40,000	1,92,800	80,000	1,09,100	3,700	1,80,000	70,900

(2) Ascertainment of excess application money adjusted against allotment

Amount received on application		1,92,800
Less: Amount required on application	80,000	
Surplus to be refunded	3,700	83,700
Excess application money to be adjusted against allotment		1,09,100

(3) Calculation of money paid by P on application

15,240 shares were allotted to	25,400 applicants
1 share was allotted to	25,400 / 15,240 applicants
300 shares were allotted to (25,400 / 15,240) x 300 = 500 “	

P applied for 500 shares and he paid on application ₹ 2 x 500 = ₹ 1,000

(4) Calculation of money payable on allotment by P

	₹
Amount paid on application	1,000
Less: Amount adjusted on application (300 x ₹ 2)	600
Excess application money	400
Money payable on allotment (300 x ₹ 4.50)	1,350
Less: Adjustment of excess application money	400
Money not paid by P	950

(5) Amount received on allotment

	₹
Amount receivable on allotment (last column of Note 1)	70,900
Less: Amount not paid by P (Note 4)	950
	69,950

Illustration 28

X Co. Ltd issued 60,000 equity shares of ₹ 10 each at a premium of ₹ 2.50 per share. The amount payable on application is ₹ 4.50 (including premium). The amount payable on allotment was fixed at ₹ 4 per share and an equivalent sum was due on a call to be made.

Total application received were for 1,10,000 shares and after consulting the Stock Exchange, the following scheme for allotment was decided upon :

Category	A	B	C
Grouping of Shares	1 to 100	101 to 500	over 500
No. of applications received	1,200	175	5
No. of shares applied for	70,000	35,000	5,000
No. of shares allotted	42,000	14,000	4,000

It was decided that the excess amount received on applications would be utilized in payment of allotment money and surplus, if any, would be refunded to the applicants. Samuel, who was one of the applicants belonging to category A and had applied for 100 shares, defaulted in payment of allotment money. Theodore, who belonged to category C, and who had been allotted 800 shares failed to pay the call money. Their shares were forfeited, after the respective calls were made and re-issued as fully paid- up for ₹ 8 and ₹ 6 per share, respectively. Show the necessary Journal Entries in the books of the company to record the above transactions. Workings should form part of your answer.

Solution

In the books of X Co. Ltd
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c (Note 1 column 3)	Dr.	4,95,000	
	To Equity Share Application A/c			4,95,000
	(Being application money received for 1,10,000 shares @ ₹ 4.50 each)			
	Equity Share Application A/c	Dr.	4,95,000	
	To Equity Share Capital A/c			1,20,000
	To Securities Premium A/c			1,50,000
	To Equity Share Allotment A/c (Note 1 column 5)			1,86,500
	To Bank A/c (Note 1 - Column 6)			38,500
	(Being application money on 60,000 shares @ ₹ 2 per share transferred to Equity Share Capital Account and @ ₹ 2.50 per share transferred to Securities Premium Account and ₹ 38,500 refunded to applicants and ₹ 1,86,500 adjusted with allotment as per Board's Resolution No. ... dated ...)			
	Equity Share Allotment A/c	Dr.	2,40,000	
	To Equity Share Capital A/c			2,40,000
	(Being allotment due on 60,000 shares @ ₹ 4 per share as per Board's Resolution No. ... dated ...)			
	Bank A/c (Note 4)	Dr.	53,440	
	To Equity Share Allotment A/c			53,440
	(Being balance allotment money received excluding that of Samuel — ₹ 60)			
	Equity Share First and Final Call	Dr.	2,40,000	
	To Equity Share Capital A/c			2,40,000
	(Being first and final call money due on 60,000 shares @ ₹ 4 each as per Board's Resolution No. ... dated ...)			

Bank A/c	Dr.	2,36,560	
To Equity Share First & Final Call A/c			2,36,560
(Being final call money received on 59,140 shares @ ₹ 4 per share)			
Equity Share Capital A/c	Dr.	8,600	
To Equity Share Allotment A/c			60
To Equity Share Final Call A/c			3,440
To Forfeited Shares A/c			5,100
(Being forfeiture of 860 shares for non-payment of allotment money on 60 shares and final call on 860 shares as per Board's Resolution No. ... dated ...)			
Bank A/c	Dr.	5,280	
Forfeited Shares A/c	Dr.	3,320	
To Equity Share Capital A/c			8,600
(Being re-issue of 60 shares @ ₹ 8 per share and 800 shares @ ₹ 6 per share as per Board's Resolution No. ... dated ...)			
Forfeited Shares A/c (Note 5)	Dr.	1,780	
To Capital Reserve A/c			1,780
(Being profit on re-issue transferred to Capital Reserve)			

Working Notes :

(1) Calculation for Adjustment and Refund

Category	No. of Shares Applied for (1)	No. of Shares Allotted (2)	Amount Received on Application (3)	Amount Required on Application (4)	Amount Adjusted on Allotment (5)	Refund [3 – (4 + 5)] (6)	Amount due on Allotment (7)	Amount Receivable on Allotment [7 – 5] (8)
(A)	70,000	42,000	3,15,000	1,89,000	1,26,000	Nil	1,68,000	42,000
(B)	35,000	14,000	1,57,500	63,000	56,000	38,500	56,000	—
(C)	5,000	4,000	22,500	18,000	4,500	Nil	16,000	11,500
TOTAL	1,10,000	60,000	4,95,000	2,70,000	1,86,500	38,500	2,40,000	53,500

(2) Ascertainment of No. of Shares Allotted to Samuel

No. of shares applied for 70,000 and no. of share allotted	42,000
No. of shares applied for 1 and no. of share allotted	42,000 / 70,000
No. of sh. applied for 100 and no. of share allotted (42,000/70,000) x 100	= 60 shares

(3) Money due on Allotment from Samuel

Application money paid	450
Less: Adjusted with application (60 x ₹ 4.50)	270
Excess application money	180
Allotment money due	240
Less: Excess application money	180
Money due on allotment from Samuel	60

(4) Allotment Money Received :

Money due on allotment = ₹ 2,40,000 Less: excess application money (adjusted) = ₹ 1,86,500 = ₹ 53,500. Less amount not paid by Samuel ₹ 60. Total = ₹ 53,440

(5) Calculation of Capital Reserve

	₹		₹
Money received from **Samuel**	450	Money received from **Theodore** (800 x 8.5)	6,800
Less: Adjusted for premium (60 x 2.5)	150	Less: Premium (800 x 2.5)	2,000
	300		4,800
Less: Loss on re-issue (60 x 2)	120	Less: Loss on re-issue	3,200
Transferred to Capital Reserve	180	Transferred to Capital Reserve	1,600

Therefore, total amount transferred to Capital Reserve = ₹ 180 + ₹ 1,600 = ₹ 1,780.

Illustration 29

Pioneers Limited issued for public subscription 60,000 Equity Shares of ₹ 10 each at a premium of ₹ 2 per share payable as follows : On application — ₹ 2 per share; on allotment — ₹ 5 per share (including premium); on first call — ₹ 2 per share; on second and final call — ₹ 3 per share.

Applications were received for 90,000 shares. Allotment was made pro rata to the applicants for 72,000 shares, the remaining applications being refused. T, to whom 2,400 shares were allotted failed to pay the allotment and first call money and his shares were forfeited. After the second and final call was made, N, to whom 3,000 shares were allotted failed to pay the two calls. His shares were also forfeited. Subsequently, out of these forfeited shares, 3,900 shares (including all shares of T), were re-issued to P as fully paid-up at ₹ 8 per share.

Show the necessary Journal Entries, Cash Book and prepare the Balance Sheet. *[C.U.B.Com. (Hons.) —Adapted]*

Solution **In the books of Pioneers Limited**

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being the application money received on 90,000 shares @ ₹ 2 each)	1,80,000		By Equity Share Application A/c (Being excess money refunded on 18,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)	36,000
	To Equity Share Allotment A/c (Note 3) (Being allotment money received on 57,600 shares @ ₹ 5 each including premium after adjustment)	2,64,960		By Balance c/d	7,13,160
	To Equity Share First Call A/c (Being first call money received on 54,600 shares @ ₹ 2 each)	1,09,200			
	To Equity Share Final Call A/c (Being final call money received on 54,600 shares @ ₹ 3 each))	1,63,800			
	To Equity Share Capital A/c (3,900 x ₹ 8) (Being money received on re-issue of shares)	31,200			
		7,49,160			7,49,160

Journal **Dr.** **Cr.**

Date	Particulars		₹	₹
	Equity Share Application A/c	Dr.	1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Being the application money on 60,000 shares @ ₹ 2 per share transferred to Equity Share Capital Account as per Board's Resolution No. . . . dated . . .)			
	Equity Share Allotment A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			1,80,000
	To Securities Premium A/c			1,20,000
	(Being allotment money due on 60,000 shares @ ₹ 5 each including premium as per Board's Resolution No. ... dated ...)			
	Equity Share Application A/c	Dr.	24,000	
	To Equity Share Allotment A/c			24,000
	(Being adjustment of surplus application money on 12,000 shares)			
	Equity Share First Call A/c	Dr.	1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Being first call money due on 60,000 shares @ ₹ 2 each as per Board's Resolution No. . . . dated . . .)			
	Equity Share Capital A/c (2,400 x ₹ 7)	Dr.	16,800	
	Securities Premium A/c (2,400 x ₹ 2)	Dr.	4,800	
	To Equity Share Allotment A/c (Note 2)			11,040
	To Equity Share First Call A/c			4,800
	To Forfeited Shares A/c (Note 1)			5,760
	(Being forfeiture of 2,400 shares for non-payment of allotment and first call money as per Board's Resolution No. ... dated ...)			
	Equity Share Final Call A/c	Dr.	1,72,800	
	To Equity Share Capital A/c			1,72,800
	(Being the amount due on final call on 57,600 shares @ ₹ 3 per share as per Board's Resolution No. ... dated ...)			
	Equity Share Capital A/c (3,000 x ₹ 10)	Dr.	30,000	
	To Equity Share First Call A/c			6,000
	To Equity Share Final Call A/c			9,000
	To Forfeited Shares A/c			15,000
	(Being forfeiture of 3,000 shares for non-payment of first and final call money as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c (3,900 x ₹ 2)	Dr.	7,800	
	To Equity Share Capital A/c			7,800
	(Being the loss on re-issue of 3,900 shares)			
	Forfeited Shares A/c (Note 4)	Dr.	5,460	
	To Capital Reserve A/c			5,460
	(Being the profit on re-issue transferred to Capital Reserve Account)			

Balance Sheet of Pioneers Limited as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,92,500
(b) Reserves and Surplus	(2)	1,20,660
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		7,13,160
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		7,13,160
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		7,13,160

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
Subscribed Capital :	
Subscribed and Fully Paid	
58,500 Equity Shares of ₹ 10 each fully paid	5,85,000
Add: Forfeited Shares	7,500
	5,92,500

(2) Reserve and Surplus

Particulars	₹
Securities Premium	1,15,200
Capital Reserve	5,460
	1,20,660

Working Notes :

(1) Calculation of Money Paid by T on Application

60,000 shares were allotted to applicants for 72,000 shares	
1 share was allotted to applicants for 72,000 / 60,000 shares	
2,400 shares were allotted to applicants of	*2,880 shares.
Therefore, money paid on application = 2,880 x ₹ 2	= ₹ 5,760

(3) Money Actually Received on Allotment

	₹
Money receivable (60,000 x ₹ 5)	3,00,000
Less: Excess application money (12,000 x ₹ 2)	24,000
	2,76,000
Less: Money not paid by T (Note 2)	11,040
	2,64,960

* (72,000 / 60,000) x 2,400

(2) Calculation of Money Payable on Allotment

	₹
Money paid on application (Note 1)	5,760
Less: Amount adjusted in application (2,400 x ₹ 2)	4,800
Excess application money	960
Allotment money payable (2,400 x ₹ 5)	12,000
Less: Excess application money	960
Money not received from T	11,040

(4) Calculation of Capital Reserve

	₹
Profit on 2,400 of T's share (Note 1)	5,760
Profit on 1,500 of N's share @ ₹ 5	7,500
	13,260
Less: Loss on re-issue of 3,900 shares @ ₹ 2 per share	7,800
	5,460

Illustration 30

X Ltd. offered 10,000 equity shares of ₹ 10 each for subscription at a premium of ₹ 2 per share payable as follows :

On application ₹ 2; On allotment ₹ 5 (including premium); On first call ₹ 2; and On final call ₹ 3.

The company received applications of 15,000 shares and allotment was made pro-rata to the applicants of 12,000 shares, the remaining applications being refused. The excess application money was adjusted on account of sums due on allotment.

Kapil to whom 500 shares were allotted failed to pay the allotment money and on his subsequent failure to pay the first call money his shares were forfeited. Srinath who originally applied for 300 shares failed to pay the two calls and his shares were also forfeited after the final call.

Subsequently, out of these forfeited shares 600 shares (including all shares of Kapil) were re-issued to Sharma as fully paid up at ₹ 9 per share.

Show the Cash Book, the Journal Entries and the Balance Sheet of the company as per ***Schedule III to the Companies Act, 2013*** to give effect to the above.

Solution

In the books of X Ltd

Cash Book (Bank column only)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being the application money received for 15,000 shares @ ₹ 2 each)	30,000		By Equity Share Application A/c (Being excess money refunded on 3,000 shares @ ₹ 2 each as per Board's Resolution No. ... dated ...)	6,000
	To Equity Share Allotment A/c (Note 1) (Being allotment money received on 9,500 shares @ ₹ 5 each including premium after adjustment)	43,700		By Balance c/d	1,19,350
	To Equity Share First Call A/c (Note 5) (Being first call money received on 9,250 shares @ ₹ 2 each)	18,500			
	To Equity Share Final Call A/c (Being final call money received on 9,250 shares @ ₹ 3 each))	27,750			
	To Equity Share Capital A/c (600 x ₹ 9) (Being money received on re-issue of shares @ ₹ 9 each)	5,400			
		1,25,350			1,25,350

In the books of X Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Equity Share Application A/c	Dr.	20,000	
	To Equity Share Capital A/c			20,000
	(Being the application money on 10,000 equity shares @ ₹ 2 each transferred to Equity Share Capital Account as per Board's Resolution No. ... dtd. ...)			
	Equity Share Application A/c	Dr.	4,000	
	To Equity Share Allotment A/c			4,000
	(Being the adjustment of surplus application money on 2,000 shares @ ₹ 2 each)			

Equity Share Allotment A/c	Dr.	50,000	
To Equity Share Capital A/c			30,000
To Securities Premium A/c			20,000
(Being the allotment money due on 10,000 shares @ ₹ 5 each including premium of ₹ 2 as per Board's Resolution No. ... dtd. ...)			
Equity Share 1st Call A/c	Dr.	20,000	
To Equity Share Capital A/c			20,000
(Being 1st call money due on 10,000 shares @ ₹ 2 per share as per Board's Resolution No. ... dtd. ...)			
Equity Share Capital A/c (500 x ₹ 7)	Dr.	3,500	
Securities Premium A/c (500 x ₹ 2)	Dr.	1,000	
To Equity Share Allotment A/c			2,300
To Equity Share 1st Call A/c			1,000
To Forfeited Share A/c			1,200
(Being the forfeiture of 500 equity shares for non-payment of allotment money and 1st call money as per Board's Resolution No. ... dtd. ...)			
Equity Share Final Call A/c	Dr.	28,500	
To Equity Share Capital A/c			28,500
(Being final call money due on 9,500 shares @ ₹ 3 each as per Board's Resolution No. ... dtd ...)			
Equity Share Capital A/c (250 x ₹ 10)	Dr.	2,500	
To Equity Share 1st Call A/c			500
To Equity Share Final Call A/c			750
To Forfeited Shares A/c			1,250
(Being the forfeiture of 2,500 equity shares for non0-payment of 1st call and final call as per Board's Resolution No. ... dtd. ....)			
Forfeited Shares A/c (600 x 1)	Dr.	600	
To Equity Share Capital A/c			600
(Being loss on re-issue of 600 shares)			
Forfeited Shares A/c (Note 6)	Dr.	1,100	
To Capital Reserve A/c			1,100
(Being the profit on re-issue transferred to Capital Reserve)			

Balance Sheet of X Ltd. as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	99,250
(b) Reserves and Surplus	(2)	20,100
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		1,19,350
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—

(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		1,19,350
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		1,19,350

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued Capital :	
10,000 Equity Shares of ₹ 10 each fully paid	1,00,000
Subscribed Capital :	
10,000 Equity Shares of ₹ 10 each fully paid	1,00,000
Paidd-up Capital :	
9,850 Equity Shares of ₹ 10 each fully paid	98,500
Add: Forfeited Shares	750
	99,250

(2) Reserve and Surplus

Particulars	₹
Securities Premium	19,000
Capital Reserve	1,100
	20,100

Working Notes :

(1) Calculation of Money Paid by Kapil on Application

10,000 shares were alloted to applicants for 12,000 shares

1 share was alloted to applicants for 12,000 / 10,000

500 shares were allotted to applicants for (12,000 / 10,000) × 500 = **600 shares.**

Money paid on application = 600 × ₹ 2 = ₹ **1,200.**

(2) Calculation of Money Payable on Allotment

	₹
Money paid on application	1,200
Less: Amount adjusted in allotment (500 × ₹ 2)	1,000
Excess application money	200
Allotment money payable by Kapil (500 × ₹ 5)	2,500
Less: Excess application money	200
Money not received from Kapil	2,300

(3) Money Actually Received on Allotment

Money receivable (10,000 × ₹ 5)	50,000
Less: Surplus application money adjusted	4,000
	46,000
Less: Money not paid by Kapil	2,300
	43,700

(4) Shares Allotted to Srinath

Srinath originally applied for 300 shares. He was allotted (10,000 / 12,000) × 300 = **250 shares.**

(5) Money received on 1st Call

Amount due (10,000 × 2)	20,000
Less: Amount not paid by Kapil (500 × ₹ 2)	(1,000)
Less: Amount not paid by Srinath (250 × ₹ 2)	(500)
	18,500

(6) Calculation of Capital Reserve

Profit on 500 shares of Kapil (Note 1)	1,200
Profit on 100 shares of Srinath @ ₹ 5	500
	1,700
Less: Loss on re-issue (600 × 1)	600
	1,100

KEY POINTS

- As per the provision of Section 2(20) of the Companies Act, 2013 'company' means a company incorporated under this Act or under any previous company law.
- The Companies Act, 2013 allows to form a company for economic as well as non-economic purposes. A company may be either: (i) a company limited by shares; or (ii) a company limited by guarantee; or (iii) an unlimited company
- 'Private Company' means a company having a minimum paid-up share capital of one lakh rupees or such higher paid-up capital as may be prescribed and which by its articles —
  (i) restricts the right to transfer its share;
  (ii) except in case of one person company, limits the number of its members to two hundred;
  (iii) prohibits any invitation to the public to subscribe for any securities of the company.
- 'One Person Company' means a company which has only one person as member'.
- 'Small Company' means a company other than a public company—
  (i) paid-up share capital of which does not exceed ***fifty lakh rupees*** or such higher amount as may be prescribed which shall not be more than ***five crore rupees***; or
  (ii) turnover of which as per last Profit and Loss Account does not exceed two crore rupees, or such higher amount as may be prescribed which shall not be more than twenty crore rupees.
- Share capital of a company limited by shares shall be of two kinds, namely,
  (a) Equity Share Capital —
  (i) with voting rights; or
  (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.
  (b) Preference Share Capital
- Equity Share Capital means all share capital which is not 'preference share' capital.
- The holder of an equity share with ***voting rights*** is entitled to vote, proportionately, in general meeting of the company.
- Preference Share Capital means that part of the issued share capital of the company which carries or would carry a preferential right with respect to—
  (a) payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and
  (b) repayment, in the case of a winding-up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.
- Unlike equity shares, preference shares carry no voting rights.
- Initial public offer means an offer of specified securities by an ***unlisted*** issuer to the public for subscription and includes an 'offer of sale' of specified securities to the public by an existing holder of such securities in an unlisted issuer.
- Further public offer means an offer of specified securities by a ***listed issuer*** to the public for subscription and includes an offer for sale of specified securities to the public by an existing holder of such securities in a listed issuer.
- Private placement means any offer of securities or invitation to subscribe securities to a select group of persons by a company through issue of a private placement ***offer letter***.

THEORETICAL QUESTIONS

1. Define a Company as per Companies Act, 2013.
2. What are the different kinds of shares which a company can issue as per the Companies Act, 2013 ?
3. Can shares be issued at a discount? If so, what are the provisions of the Companies Act, 2013 in this regard ?
4. State the purposes for which securities premium can be utilised.
5. What do you mean by 'Calls-in-Arrear' and 'Calls-in-Advance'? What are the provisions of Companies Act, 2013 in this regard?
6. How can the profit on re-issue of forfeited shares be treated in accounts ?
7. What is one man company ? What are the characteristics of this type of company ?
8. What do you mean by a small company as per the provisions of Companies Act, 2013 ?
9. What are the advantages of issuing preference shares ?
10. What do you mean by (i) Authorised Capital; (ii) Issued Capital; (iii) Subscribed Capital; and (iv) Paid-up Share Capital
11. What do you mean by Further Issue of Shares (FPO) ? State the conditions for Further Issue of Shares.
12. What is depository system ? What are the advantages and limitations of depository system ?

13. What do you mean by 'book building' method of issuing shares ?
14. What is 'Sweat Equity' Shares ? State four important rules as per the Companies (Share Capital and Debentures) Rules, 2014 in this respect.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Which of the following is not a characteristic of a company ?
   A A company is a legal entity separate and distinct from its members.
   B A shareholder of a company, in its individual capacity, can bind the company.
   C The shareholders of a company can enter into a contract with the company.
   D A company must have a registered office.
2. A company is managed by the
   A managing director
   B persons selected by the company law board
   C board of directors
   D promoters
3. Which of the following is not a characteristic of equity share ?
   A it is the risk capital of the company
   B it has voting power
   C it has no preferential right to divided
   D it can be converted into preference share
4. Preference shares must be redeemed within
   A 10 years from the date of issue of such share
   B 15 years from the date of issue of such share
   C 20 years from the date of issue of such share
   D 25 years from the date of issue of such share
5. Which of the following is not a characteristic of a public limited company ?
   A its shares are freely transferable
   B the number of directors should be at least 3
   C in a public company, there may be any number of members
   D a public company can be incorporated with less than 7 persons and more than 2 persons
6. Issued capital is the part of
   A subscribed capital
   B authorized capital
   C called-up capital
   D paid-up capital
7. 'Reserve capital' can be called up
   A in an emergency only
   B any time by passing an ordinary resolution
   C in the event and for the purposes of the company being wound-up
   D if all directors agree
8. Subscribed capital can be
   A more than called-up capital
   B more than issued capital
   C more than authorized capital
   D equal to reserve capital
9. At the time of public issue of shares, which of the following steps are observed ?
   A issue of prospectus→selection of merchant banker→cash received from applicants
   B issue of prospectus→cash received from applicants→selection of merchant banker
   C selection of merchant banker→cash received from applicants→issue of prospectus
   D selection of merchant banker→issue of prospectus→cash received from applicant

10. Shares can be issued by a public company through
    A public offer only
    B private placement only
    C rights / bonus issue
    D all the above
11. Which of the following is not true for stock ?
    A stock is in lump holding
    B stock can be issued directly
    C stock must be fully paid
    D stock is never numbered
12. The minimum application moneys to be paid by an applicant along with the application money shall not be less than
    A 20% of the face value of the shares
    B 20% of the issue price
    C 25% of the issue price
    D 25% of the value of the shares
13. In case of a public issue, the underwriting of shares is
    A mandatory
    B optional
    C mandatory if the issue size is more than 100 crores
    D mandatory if the issue size is more than 100 crores but less than 500 crores
14. Calls-in-arrear is shown in the Balance Sheet
    A on the assets section under 'Current Assets'
    B on the equity and liabilities section under 'Share Capital' as a separate item
    C on the equity and liabilities section as a deduction from paid-up capital
    D on the equity and liabilities section under 'Current Liabilities'
15. Calls-in-advance is shown in the Balance Sheet
    A on the liabilities section as a part of share capital
    B on the liabilities section under 'Current Liabilities' as a separate item
    C on the assets section as a deduction of cash and bank
    D on the assets section as a separate item under 'Current Assets'
16. Which of the following statement is true for 'Commission on Issue of Shares' ?
    A it is shown in the Balance Sheet as a liability
    B it is capitalised and shown in the Balance Sheet permanently
    C it is capitalised but written-off gradually
    D it is written-off immediately to Profit and Loss Account / Reserves
17. As per Table F of Schedule I to the Companies Act, 2013, interest on calls-in-arrear is payable
    A @ 6% p.a.
    B @ 5% p.a.
    C @ 10% p.a.
    D @ 12% p.a.
18. At the time of forfeiture of shares
    A share capital account is credited with the called-up value of shares forfeited
    B share capital account is debited with the face value of shares forfeited
    C share capital account is debited with the called-up value of shares forfeited
    D share capital account is neither debited nor credited
19. Till the forfeited shares are re-issued, balance of Forfeited Shares A/c will be shown in Balance Sheet
    A as a separate item
    B as a part of the subscribed capital
    C as an item of reserve and surplus
    D as a part of the paid-up capital
20. Profit on re-issue of shares is transferred to
    A profit and loss account
    B general reserve
    C capital redemption reserve
    D capital reserve

21. Shares are issued
    A for cash only
    B on credit only
    C for cash or for consideration other than cash
    D for consideration other than cash only
22. The minimum application value shall be within the range of
    A ₹ 5,000 to ₹ 10,000
    B ₹ 2,000 to ₹ 5,000
    C ₹ 10,000 to ₹ 15,000
    D ₹ 10,000 to ₹ 20,000
23. A company can issue equity shares with differential rights as to dividends, voting or otherwise
    A if it is authorised by articles of association only
    B if the issue is authorised by special resolution only
    C if it is authorised both by articles of association and special resolution
    D if it is authorised both by articles of association and ordinary resolution
24. The face of equity share
    A cannot be less than ₹ 10 in any circumstances
    B can be less than ₹ 10 if the issue price is less than ₹ 500
    C can be less than ₹ 10 if the issue price is less than ₹ 400
    D can be less than ₹ 10 if the issue price is ₹ 500 or more
25. An issuer shall not make an allotmnent pursuant to a public issue of the number of the prospectrive allottes is
    A less than 200
    B less than 500
    C less than 1,000
    D none of the above

PRACTICAL QUESTIONS

Issue and Forfeiture of Shares

1. A Limited company issued 10,000 shares of ₹ 10 each payable as ₹ 2 on application; ₹ 3 on allotment; and ₹ 5 on final call. The public applied for 9,000 shares, which were allotted. All the monies due on shares were received except the final call on 400 shares. Pass necessary Journal entries (including cash) and show the Balance Sheet.
2. A limited company has its issued capital comprising of 20,000 equity shares of ₹ 10 each payable as : ₹ 2 on application; ₹ 3 on allotment (including premium); ₹ 3 on first call; and ₹ 3 on final call.
   The shares were called up to the first call stage. All the share money was received except from A, holding 300 shares, who paid only the application money, and B holding 200 shares who paid up to allotment. All these shares were forfeited. Of these forfeited shares, 400 shares (whole of A's holdings and balance of B's holdings) were reissued to C, on payment of ₹ 6 per share and as paid-up to the same extent as the other shares.
   Pass Journal Entries for forfeiture and reissue only.
3. On April 1, 2017, the directors of ABC Ltd issued 1,00,000 equity shares of ₹ 10 each at ₹ 12 per share payable at ₹ 5 on application, ₹ 4 on allotment including premium and the balance on July 1, 2017.
   The lists closed on April 12, 2017, by which date applications for 1,40,000 shares had been received. Of the cash received, ₹ 80,000 was returned and ₹ 1,20,000 was applied to the amount due on allotment, the balance of which was paid on April 19, 2017. All shareholders paid the call due on July 1, 2017, with the exception of one allottee for 1,000 shares. These shares were forfeited on November 30, 2017 and reissued as fully paid at ₹ 8 per share on January 2, 2017. Pass Journal Entries in the books of the company recording the above transactions.
4. Bijon Trading Co. Ltd was registered on 2nd January, 2017, with 10,000 equity shares of ₹ 10 each. The Company offered 8,000 shares for subscription to public. The condition was that ₹ 3 per share is payable on application, ₹ 5 per share including ₹ 2 as premium is payable on allotment, ₹ 2 per share on 1st Call and₹ 2 per share on 2nd and Final Call.
   The Company received application for 9,000 shares on 15th January, of which applications for 500 shares were cancelled and money in this respect was refunded. Application money on another 500 shares was transferred to Allotment Account, 8,000 shares were allotted in due course. Money due on allotment was received in time.
   The company made 1st Call on 30th January and received money in due time excepting on 600 shares. Subsequently the company forfeited these 600 shares for non-payment of 1st Call.
   ₹cord the above transactions in Journal and show the balances as they would appear on the Balance Sheet.

5. M. Khaitan Ltd was formed with an authorised capital of 20,000 equity shares of ₹ 10 each to purchase the business of M. Khaitan for ₹ 1,00,000 by the allotment of fully paid shares.
   On July 1, 2016, the purchase consideration was satisfied and 9,000 shares were subscribed for by the public at par, ₹ 2 per share being payable on application and ₹ 1 per share on allotment. A first call of ₹ 2.50 per share was due on September 1 and a second call of ₹ 2 per share on November 1.
   On December 31, 2016, the position as regards shares subscribed by the public was as follows:

Number of shares :	8,900	60	30	10
Amount paid per share :(₹)	7.50	5.50	3.00	2.00

   On December 31, 2016, all shares on which less than ₹ 5.50 per share had been paid were forfeited.
   On February 28, 2017, the arrears on 60 shares were collected.
   On March 1, 2017, the forfeited shares were sold to Goenka at the price of ₹ 8.50 per share. The shares were reissued as fully paid-up.
   On April 1, 2017, the directors made a final call of ₹ 2.50 per share, payable on June 1. The amount was duly received.
   Draft Journal Entries to record all the above transactions. Cash transactions are to be passed through the Cash Book.

Pro-rata Allotment

6. East Coast Ltd made an issue of 30,000 shares of ₹ 10 each payable as ₹ 3 on application; ₹ 5 on allotment; and ₹ 2 on call. 93,200 shares were applied for and owing to this heavy over-subscription, allotments were made as under:
   (1) Applicants for 21,500 shares (in respect of applications for 2,000 shares or more) received 10,200 shares.
   (2) Applicants for 50,600 shares (in respect of applications for 1,000 shares or more but less than 2,000 shares)received 12,600 shares.
   (3) Applicants for 21,100 shares (in respect of applications for less than 1,000 shares) received 7,200 shares. Cash thus received after satisfying the amount due on application was applied towards allotment and call money and any balance was then returned. All monies due on allotment and calls were received.
   Pass necessary Journal Entries and show Cash Book and Ledger Accounts relating to this issue in the books of the company.
7. A Ltd issued 1,00,000 shares of ₹ 10 each payable as follows : ₹ 3 on application, ₹ 2 on allotment, ₹ 3 on first call and ₹ 2 on final call. Applications were received for 1,60,000 shares out of which letters of regret were issued for 30,000 shares. Full allotment was made to applicants for 40,000 shares. Pro-rata allotment was made on the balance. A shareholder holding 100 shares, to whom full allotment was made, failed to pay allotment money. Another shareholder holding 200 shares, to whom pro-rata allotment was made, also failed to pay allotment money. On first call, there was a further default on 300 shares. All these were forfeited. The first lot of 300 shares was reissued at the rate of ₹ 8 per share as fully paid-up shares. Pass necessary Journal Entries.
8. Alfa Trading Co Ltd offered 10,000 equity shares of ₹ 10 each for subscription at a premium of ₹ 2 per share payable as :On Application ₹ 3, on Allotment ₹ 4 (including premium), on First and Final Call ₹ 5.
   The company received application for 10,250 shares, 10,000 shares were allotted pro-rata in due course and excess money is to be adjusted with allotment. Money due on allotment was received in time. The company made First and Final Call and received money in due time excepting on 100 shares. Subsequently, the company forfeited those 100 shares for non- payment of call and re-issuedto Sri Ram at ₹ 7 per share as fully paid-up.
   Journalise the above transactions and show the Cash Book.
9. A limited company invited applications for 10,000 shares of ₹ 10 each at a premium of ₹ 5 per share payable as :
   On application ₹ 3 per share, on allotment ₹ 6 per share including premium and balance in two calls of equal amounts. Applications were received for 18,000 shares and allotment was made to applicants of 15,000 shares at the rate of two shares for every three applied for. Sen failed to pay the allotment money for the 40 shares allotted to him and these shares were forfeited when he failed to pay the 1st call. Basu failed to pay the calls in respect of 120 shares allotted to him and these shares were forfeited after the second call. 40 shares allotted to Sen originally and another 40 shares allotted to Basu were later re-issued to Ghosh as fully paid-up on payment of ₹ 9 per share.
   Show the relevant entries in the Cash Book and Journal of the company. Show also how these shares will appear on the Balance Sheet.
10. New Company Ltd issued 50,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share payable as: On Application— ₹ 3 per share; on Allotment — ₹ 5 per share (Including Premium); on First Call — ₹ 2 per share; on Final Call — ₹ 2 per share. Applications were received for 80,000 shares. Allotments were made pro-rata to applicants for 60,000 shares and other applications were refused. One of the allottees Sri B. Chakrabarty who was allotted 1,030 shares failed to pay the allotment money. Another Sri Anil Mukherjee who was allotted 5,000 shares failed to pay the final call. All these 6,030 shares were forfeited after the final call was made. Three months later, these shares were re-issued at ₹ 7 per share.
    Show the Journal Entries required to record the above noted transactions.

11. A. Ltd invited applications for 1,00,000 of its Equity Shares of ₹ 10 each on the following terms:
    (i) Payable on application on 31st January, 2017 ₹ 5 per share including premium. (ii) Payable on allotment on 28th February, 2017, ₹ 4 per share, (iii) Payable on first and final call on 31st July, 2017, ₹ 3 per share.
    Applications for 1,25,000 shares were received.
    It was decided :
    (a) to refuse allotment to the applicants of 5,000 shares;
    (b) to allot in full to applicants for 20,000 shares;
    (c) to allot the balance of the available shares pro-rata among the other applicants; and
    (d) to utilise excess application moneys in part payment of allotment moneys.
    One applicant to whom shares had been allotted on Pro-rata basis, did not pay the amount due on allotment and on call and his 200 shares were forfeited on September 30,2017. The shares werere-issued on November 30,2017 at ₹ 9.50 per share.
    Show the Journal and cash book entries necessary to record the foregoing transactions.
12. Analysts Limited had issued 1,00,000 equity shares of ₹ 10 each to the public at a premium of ₹ 2 per share. The amount was payable as follows : On application ₹ 3; on allotment ₹ 5 (including premium); on first call ₹ 2 and on second call ₹ 2.
    Applications were received for 1,50,000 equity shares and allotment was made pro-rata to all applicants. Excess amounts paid on applications were adjusted against allotment moneys due. Mr. X who was allotted 500 shares did not pay the allotment money and the two calls. Consequently, his shares were forfeited. Out of the forfeited shares, 300 shares were re-issued to Mr. Y at ₹ 10 per share.
    Pass necessary Journal Entries (including cash transactions) in the books of the company to record the above transactions and also show the Balance Sheet.
13. Hindustan Limited invited applications for 1,00,000 shares of ₹ 10 each at a price of ₹ 11 payable ₹ 4 on application (including premium), ₹ 4.50 on allotment and balance on first and final call. Applications were received for 1,20,000 shares. Allotment was made as : to applicants of 80,000 shares : 100%; to applicants of 40,000 shares : pro-rata to all applicants. Excess application money was adjusted against further money payable. Mr. Rahul, to whom 1,000 shares were allotted on a pro-rata basis, failed to pay the allotment and call money. Mr. Sanjay, to whom 500 shares were allotted failed to pay the call money. All these shares were forfeited after final call. Out of these shares, 1,250 (all of Rahul) were issued to Rajiv @ ₹ 9 each.
    Pass necessary entries (including cash transactions) and also show Balance Sheet.
14. Applications were invited by the directors of Grobigg Ltd for 15,000 of its equity shares at ₹ 115 per share payable as follows:
    (a) On application on 1st April, 2017 (including premium of ₹ 15 per share) ₹ 75;
    (b) On allotment on 30th April, 2017 ₹ 20; and
    (c) On first & final call on 31st May 2017 ₹ 20. Applications were received for 18,000 shares and it was decided to deal with these as follows:
    1. To refuse allotment on applicants for 800 shares.
    2. To give full allotment to applicants for 2,200 shares.
    3. To allot the remainder of the available shares pro-rata among the other applicants.
    4. To utilize the surplus received on applications in part payment of amounts due on allotment.
    An applicant, to whom 400 shares had been allotted, failed to pay the amount due on the first and final call and his shares were declared forfeited on 31st July 2017.These share were re-issued on 3rd September, 2017 as fully paid at ₹ 90 per share.
    Pass Journal entries including cash items.
15. Ronak Ltdwasregisteredwithanominalcapitalof₹ 2,00,000 in equity shares of ₹ 10 each and 10,000 of these shares were issued to the public at a premium of 20%. The amount payable was as follows : ₹ 2 on application; ₹ 4.50 on allotment (including premium); ₹ 2.50 on first call; ₹ 3 on final call. Applications were received for 13,000 shares and allotment was made as : to applicants of 12,000 shares : pro-rata and to applicants of 1,000 shares : Nil.
    Amount overpaid on application was employed on account of sums due on allotment. X holding 200 shares paid the whole of the amount due on first call along with allotment, but failed to pay the final call. Y holding 300 shares failed to pay the two calls and Z holding 400 shares failed to pay the final call only. All these shares were forfeited after the final call. Of the shares forfeited 200 shares of Y and 300 shares of Z were sold to Mr P as fully paid for ₹ 90 per share.
    You are required to prepare the following Ledger Accounts : (i) Share Capital Account; (ii) Securities Premium Account; (iii) Share Allotment Account; (iv) Share First Call Account; (v) Share Final Call Account; and (vi) Share Forfeiture Account.

16. M/s Blue Chips Ltd issued 5,000 Equity Shares of ₹ 100 each at a premium of ₹ 25 per share. On 1st January, 2017 the company received 12,000 applications of which 2,000 applications were totally rejected and their amount was refunded on 1st February, 2017, when remaining applicants were allotted shares on pro-rata basis. The amount of shares receivable is : On application ₹ 30; on Allotment ₹ 45 (including premium); On 1st Call ₹ 25; on 2nd Call ₹ 25. Allotment money was received in full on 15th February, 2017.
    First call was made on 15th May, 2017 and received on 1st June 2017 except on 25 shares hold by Mr Azad. His shares were forfeited on 1st October, 2017 and re-issued on 15th October, 2017, credited at ₹ 75 paid for ₹ 110 per share to Mr. Anand.Final call was made on 1st November, 2017 and received on 15th November, 2017 except on 100 shares held by Mr. Banarasidas.
    Pass journal entries in the books of Blue chips Ltd (including relating theCash).
17. A limited company issued 90,000 shares of ₹ 10 each at a premium of ₹ 3 per share payable as follows :
    On application ₹ 6 (including premium) per share, on allotment ₹ 5 per share and on call ₹ 2 per share.
    Applications were received for 2,79,600 shares and allotment were made as under :
    (a) Applicants for 64,500 received 30,600 shares.
    (b) Applicants for 1,51,800 received 37,800 shares.
    (c) Applicants for 63,300 received 21,600 shares.
    Amount received with application, after satisfying application money, was applied towards allotment and call money and any balance was then returned.
    One shareholders falling in the category (c) mentioned above failed to pay allotment in respect of 100 shares and these shares were immediately forfeited.
    Show Journal Entries in the books of the company.
17. The directors of XYZ Limited invited applications for 2,00,000 Equity Shares of ₹ 10 each to be issued at 20% premium. The money payable on shares is as follows : on application ₹ 5, on allotment ₹ 4 (including premium of ₹ 2), first call ₹ 2 and final call ₹ 1.
    Applications were received for 2,40,000 shares and allotment was made as follows : (a) to applicants for 1,00,000 shares — in full; (b) to applicants for 80,000 shares — 60,000 shares; (c) to applicants for 60,000 shares — 40,000 shares.
    Applicants of 1,000 shares falling in category (a) and applicants of 1,200 shares falling in category (b) failed to pay allotment money. These shares were forfeited on failure to pay the first call. Holders of 1,200 shares falling in category (c) failed to pay the first call and final call and these shares were forfeited after final call.
    1,300 shares [1,000 of category (a) and 300 of category (b)] were re-issued at ₹ 8 per share as fully paid.
    Journalise the above transactions. Show Cash Book and prepare Balance Sheet as per ***Schedule III to the Companies Act, 2013***.
18. Super Star Ltd offered 10,000 equity shares of ₹ 100 each for subscription at a premium of ₹ 20 per share payable as follows: on application ₹ 10; on allotment ₹ 40 (including premium); on 1st call ₹ 20; on 2nd call ₹ 30 and on final call ₹ 20. The company received applications for 12,000 shares and 10,000 shares were allotted pro-rata.
    Holder of 400 shares failed to pay the 1st call and after due notice their shares were forfeited. The amount payable on the 2nd call were paid in full, except that a holder of 200 shares failed to pay. 250 of the 400 shares forfeited were re-issued, credited with ₹ 80 paid for ₹ 50 per share. The final call was met in full including the arrears of the second call.
    Show necessary Journal entries including cash in the books of the company.

Guide to Answers

Multiple Choice

1. B; 2. C; 3. D; 4. C; 5. D; 6. B; 7. C; 8. A; 9. D; 10. D; 11. B; 12. C; 13. B; 14. C; 15. B; 16. D; 17. C; 18. C; 19. D; 20. D; 21. C 22. C; 23. D; 24. D; 25. C.

Practical Questions

1. **Calls-in-arrear ₹ 2,000; Balance Sheet Total ₹ 88,000.**
2. **Transfer to capital reserve ₹ 600 (A : ₹ 300 + B : ₹ 300).**
3. **Transferred to capital reserve ₹ 5,000.**
4. **Balance of forfeited shares account ₹ 3,600.**
5. **Transferred to capital reserve ₹ 50.**
6. **Adjusted against allotment ₹ 1,32,900; Refunded ₹ 25,800; Calls in advance ₹ 30,900.**
7. **Transferred to capital reserve ₹ 600. Balance of forfeited shares ₹ 1,500.**
8. **Transferred to capital reserve ₹ 200.**
9. **Transferred to capital reserve ₹ 260.**

10. **Money not received on allotment ₹ 4,532. Money actually received on allotment ₹ 2,15,468. Amount forfeited : (i) B. Chakraborty ₹ 3,708, and (ii) Anil Mukherjee ₹ 40,000. Transferred to capital reserve ₹ 25,618.**
11. **Ratio of pro-rata 10 : 8; Money not received on allotment ₹ 550. Transferred to capital reserve ₹ 750.**
12. **Transferred to capital reserve ₹ 1,350.**
13. **Transferred to capital reserve ₹ 7625.**
14. **Amount transferred to capital reserve ₹ 28,000. Money adjusted with allotment ₹ 1,65,000. Ratio of pro-rata allotment 75:64.**
15. **Transferredtocapitalreserve₹ 2,500.Balanceofforfeitedshares account ₹ 2,550. amount received on allotment ₹ 41,000.**
16. **Forfeited amount ₹ 1,250.**
17. **Amount refunded ₹ 5,18,400; Money received on call ₹ 10,800.**
18. **Amount transferred to Capital Reserve ₹ 4,400. Total of the Balance Sheet ₹ 23,95,000. Subscribed and Paid-up Capital ₹ 19,94,400.**
19. **Amount transferred to Capital Reserve — Nil.**

Appendix — A

Some Book-Building Related Matters

Categories of Applicants

Under book-building process, applicants are categorised under the following three heads :

(1) Retail Individual Bidders

These are individuals (including NRIs and HUFs) who can apply for shares up to the value of ₹ 2,00,000. In other words, this category is defined as one where the investment should not exceed ₹ 2,00,000 . This means that, for a retail investor, it will restrict the number of shares that one can bid in order to qualify under this category. The figures will differ from issue to issue — depending upon the issue price of the shares.

For example,

INOX Wind Ltd.'s issue details are as follows :
Issue Open : March 18, 2017 – March 20, 2017
Issue Type : 100% Book Built Issue IPO
Face Value : ₹ 10 per share
Issue Size : ₹ 700.00 Crore
Price Band : ₹ 315 - ₹ 325 per equity share
Market Lot : 45 Shares
Minimum Bid : 45 Shares

As the 'price band' is ₹ 315 - ₹ 325, a retail investor can bid at any price between ₹ 315 and ₹ 325, but he will have to bid for 45 shares or multiple of 45 shares. However, the total amount of bid cannot exceed ₹ 2,00,000.

Case 1 : Let us assume that X is interested to bid at ₹ 315. Therefore, he can bid for ₹ 2,00,000 ÷ ₹ 315 = 635 shares or 14.11 lots of 45 shares (635 ÷ 45).

It is clear that X can bid for 14 lots of 45 shares, i.e., 14 × 45 = 630 shares.

His bid value will be 630 × ₹ 315 = **₹ 1,98,450.** It is not exceeding ₹ 2,00,000.

Case 2 : Let us assume that Y is interested to bid at ₹ 320. Therefore, he can bid for ₹ 2,00,000 ÷ 320 = 625 shares or 13.88 lots of 45 shares (625 ÷ 45). Here Y will have to bid for 13 lots of 45 shares or 585 shares.

He cannot bid for 14 lots, i.e., 14 × 45 = 630 shares as in that case his bid value will exceed ₹ 2,00,000 (630 × ₹ 320 = **₹ 2,01,600**).

Case 3 : Let us assume that Z is interested to bid at ₹ 325. Therefore, he can bid for ₹ 2,00,000 ÷ 325 = 615 shares or 13.67 lots of 45 shares (615 ÷ 45). Here, Z will have to bid for 13 lots of 45 shares or 585 shares.

He cannot bid for 14 lots, i.e., 630 shares as in that case his bid value will exceed ₹ 2,00,000 (630 × 325) = **₹ 2,04,750.**

Therefore, before making any investment, a retail investor should keep in his mind that his total investment does not exceed ₹ 2,00,000.

(2) Non-Institutional Bidders

These are resident Indian Individuals, Hindu Undivided Family (in the name of Karta), companies, corporate bodies, NRIs, societies and trusts. Unlike retail individual bidders, this category is defined as one where the investment should exceed ₹ 2,00,000.

(3) Qualified Institutional Bidders / Buyers (QIBs)

As per SEBI (ICDR) Regulations, 2009 "Qualified Institutional Buyer" means:

(i) a mutual fund, venture capital fund, Alternatively investment fund and foreign venture capital investor registered with the Board;
(ii) a foreign portfolio investor other than Category III foreign portfolio investor, registered with the Board;
(iii) a public financial institution;

(iv) a scheduled commercial bank;
(v) a multilateral and bilateral development financial institution;
(vi) a state industrial development corporation;
(vii) an insurance company registered with the Insurance Regulatory and Development Authority;
(viii) a provident fund with minimum corpus of twenty five crore rupees;
(ix) a pension fund with minimum corpus of twenty five crore rupees;
(x) National Investment Fund set up by the Government of India published in the Gazette of India;
(xi) insurance funds set up and managed by army, navy or air force of the Union of India;
(xii) insurance funds set up and managed by the Department of Posts, India.

SEBI (ICDR) Regulations, 2009

Allocation in Net Offer* to Public

(1) No person shall make an application in the net offer to public category for that number of specified securities which exceeds the number of specified securities offered to public.

(2) In an issue made through the book building process under sub-regulation (1) of regulation 26, the allocation in the net offer to public category shall be as follows:
- (a) not less than thirty five per cent to retail individual investors;
- (b) not less than fifteen per cent to non-institutional investors;
- (c) not more than fifty per cent to qualified institutional buyers, five per cent. of which shall be allocated to mutual funds:

Provided that in addition to five per cent allocation available in terms of clause (c), mutual funds shall be eligible for allocation under the balance available for qualified institutional buyers.";

(2A) In an issue made through the book building process under sub-regulation (2) of regulation 26, the allocation in the net offer to public category shall be as follows:
- (a) not more than ten per cent to retail individual investors;
- (b) not more than fifteen per cent to non-institutional investors;
- (c) not less than seventy five per cent to qualified institutional buyers, five per cent of which shall be allocated to mutual funds:

Provided that in addition to five per cent. allocation available in terms of clause (c), mutual funds shall be eligible for allocation under the balance available for qualified institutional buyers.

Price Band

The important element worth understanding is the concept of Price Band in book-building process.

Price Band is an expression that is generally associated with book-building exercise in the context of public issue of shares. It is a process whereby the company mentions the minimum and maximum price. We suppose, a company invites applications for its shares of ₹ 10 each within the price band for ₹ 20 to ₹ 24. The lower of the price band, i.e., ₹ 20, is called the ***floor price*** and the higher of the price band, i.e., ₹ 24, is called the ***cap price***. In this case, the company is informing the investors that it will not settle for anything less than ₹ 10 (₹ 20 – ₹ 10) per share as premium. And simultaneously it also tells that it will not accept anything more than ₹ 14 (₹ 24 – ₹ 10) per share as premium. The investors cannot bid below the floor price offered or above the cap price. In other words, an investor can bid at any price between floor and cap price (in multiples of ₹ 1). The price at which the shares are finally offered to the investors is known as ***cut-off*** price. In this connection, it should be remembered that a company can mention a price band of a maximum limit of 20% (cap in the price band should not be more than 20% of the floor price).

Bidding Process

(a) Bidding process shall be only through an electronically linked transparent bidding facility provided by recognised stock exchange(s).

(b) The lead book runner shall ensure the availability of adequate infrastructure with syndicate members for data entry of the bids in a timely manner.

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* Net Offer = Total shares to be issued *less* Shares issued to promoters and/or investors.

(c) The syndicate members shall be present at the bidding centres so that at least one electronically linked computer terminal at all the bidding centres is available for the purpose of bidding.

(d) During the period the issue is open to the public for bidding, the applicants may approach the stock brokers of the stock exchange/s through which the securities are offered under on-line system or Self Certified Syndicate Banks, as the case may be, to place an order for bidding for the specified securities.

(e) Every stock broker shall accept orders from all clients/investors who place orders through him and every Self Certified Syndicate Bank shall accept Applications Supported by Blocked Amount from ASBA investors.

(f) Applicants who are qualified institutional buyers shall place their bids only through the stock brokers who shall have the right to vet the bids;

(g) The bidding terminals shall contain an online graphical display of demand and bid prices updated at periodic intervals, not exceeding thirty minutes.

(h) At the end of each day of the bidding period, the demand including allocation made to anchor investors, shall be shown graphically on the bidding terminals of syndicate members and websites of recognised stock exchanges offering electronically linked transparent bidding facility, for information of public.

(i) The retail individual investors may either withdraw or revise their bids until finalization of allotment.

(ia) The issuer may decide to close the bidding by qualified institutional buyers one day prior to the closure of the issue subject to the following conditions:
(i) bidding shall be kept open for a minimum of three days for all categories of applicants;
(ii) disclosures are made in the red herring prospectus regarding the issuer's decision to close the bidding by qualified institutional buyers one day prior to closure of issue.

(j) The qualified institutional buyers and the non-institutional investors shall neither withdraw nor lower the size of their bids at any stage.

(k) The identity of qualified institutional buyers making the bidding shall not be made public.

(l) The stock exchanges shall continue to display on their website, the data pertaining to book built issues in an uniform format, inter alia giving category-wise details of bids received, for a period of atleast three days after closure of bids. Such display shall be as per the format specified in Part B of this Schedule.

Determination of Price

(a) The issuer shall, in consultation with lead book runner, determine the issue price based on the bids received

(b) On determination of the price, the number of specified securities to be offered shall be determined (i.e. issue size divided by the price to be determined).

(c) Once the final price (cut-off price) is determined, all those bidders whose bids have been found to be successful (i.e. at and above the final price or cut-off price) shall be entitled for allotment of specified securities.

(d) Retail individual investors may bid at "cut off" price instead of their writing the specific bid price in the bid forms.

(e) The lead book runner may reject a bid placed by a qualified institutional buyer for reasons to be recorded in writing provided that such rejection shall be made at the time of acceptance of the bid and the reasons therefor shall be disclosed to the bidders. Necessary disclosures in this regard shall also be made in the red herring prospectus.

The following companies issued shares under 'Book Building' process during 2014-15 :

Issuer Company	Issue Open	Issue Close	Offer Price (₹)	Issue Size (₹ Crore)
Inox Wind Limited	March 18, 2015	March 20, 2015	310	700.00
Adlabs Entertainment Ltd.	March 10, 2015	March 12, 2015	168	341.48
Ortel Communications Ltd.	March 3, 2015	March 5, 2015	181	217.20
Monte Carlo Fashions Ltd.	December 3, 2014	December 5, 2014	645	350.43
Shemaroo Entertainment Ltd.	September 16, 2014	September 18, 2014	153	120.00

Sharda Cropchem Ltd.	September 5, 2014	September 9, 2014	156	351.86
Snowman Logistics Ltd.	August 26, 2014	August 28, 2014	47	197.40
Wonderla Holidays Ltd.	April 21, 2014	April 23, 2014	125	181.25

Green Shoe Option

When a company makes a public offer of equity shares (among others) there are many short term investors who make applications for the shares. They know that if the issue is oversubscribed, the company will not be able to satisfy all the applicants. As a result, there will be an excess demand for the shares and, in effect, these shares are likely to be traded in the future at a price higher than the one offered to the successful applicants. These short term investors, known as ***flippers***, prefer bargain hunting. They have limited information on the company issuing shares and they believe that the price at which it is offered to the public is lower than the price at which it will be traded in the stock market, when traded. For such an investor, it is just like buying a lottery ticket, because he believes that if he gets an allotment, he is sure to make money in the short run by selling those shares.

Once the shares get listed in the stock exchange and trading of those shares starts, there may be fluctuation on the market prices of the shares. It can be one of the following :

(1) If the selling pressure is very high, prices of the shares will go down; or

(2) If there is excess demand, share prices may go up.

A green shoe option is an option given to a company to allot additional number of shares, if necessary, than originally it intends to issue. Therefore, a green shoe option (GSO) is an over allotment option and is essentially a device to ensure post issue price stability — a period that is undoubtedly the most crucial from the viewpoint of an investor. A green shoe option aims to stabilise the market price of the equity share, close to the offer price, during one month immediately following listing. The main purpose of 'stabilisation' is to provide support for the price of the new issue, if it comes down under selling pressure. It should go a long way in the process of rebuilding investor confidence.

The expression 'green shoe option' is derived from the fact that over-allotment option technique was first used in the initial public offer of shares of a company called The Green Shoe Company. In India, the first company to offer shares to the public under green shoe option was ICICI Bank, followed by Tata Consultancy Services (TCS) and others.

A hypothetical case would be as under :

Pre-issue

X Limited announces a public issue of 1,00,000 equity shares of ₹ 10 each at par, payable fully on application. The company has, through its prospectus, given a 15% green shoe option. This means that the company will lend 15,000 shares from the promoters or any other existing shareholder, and ultimately will issue 1,15,000 shares to the public. The additional 15,000 shares are to be returned to them either by buying back from the market (after allotment) or by issuing new shares. This option is valid for a period of one month, post listing.

Post-issue

Scenario 1 : After listing, if the share prices decline, the company starts buying the shares from the market to stabilise the price. The company, in this case, can buy back up to a maximum of 15,000 shares. After buying back, the shares are returned to the lender(s). In effect, the company issues only 1,00,000 shares. The point to note is that the company does not exercise the green shoe option, i.e., not issuing extra 15,000 shares. By the process of stabilisation (buying back 15,000 shares from the market), an investor can see a better market price for the shares relative to what it would have been.

Scenario 2 : Owing to excessive demand if the share prices rise after listing, the company is not required to stabilise the price. Here, the company has to exercise the green shoe option. In such a situation, the company will issue addition 15,000 shares and gives those back to the lender(s). Unlike scenario 1, the company issues 1,15,000 shares in total.

Green shoe option is available in all public issues, viz., initial public offers (including fresh issue or offer for sale), follow-on offerings, public issues either through book building or fixed price route.

The green shoe option provides a 'safety net' to the investors since there is an assurance that the offer price will be maintained for a period of one month. The main advantage from the viewpoint of the company is that investors tend to give better pricing to offers with a green shoe option as they are relieved from the fact that during the post listing period the stabilising agent would ensure price stability.

The green shoe option also ensures that the prices of the shares are not abnormally higher than the offer price. As a result of oversubscription, there may be an excess demand for the shares that can make the prices go skyrocketing. The issue of additional shares matches this excess demand.

Resolution of the Green Shoe Option

An issuer company making a public offer of equity shares and is desirous of availing of green shoe option, shall in the resolution of the general meeting authorising the public issue, seek authorisation also for the possibility of allotment of further shares to the stabilising agent (SA) at the end of the stabilisation period.

Disclosure in the Prospectus

The prospectus shall contain the following disclosures (along with others) :

(1) Name of the stabilising agent.
(2) Maximum number of shares proposed to be over-allotted.
(3) The stabilisation period.

The Process of Green Shoe Option

(1) The issuer company shall appoint one of the head Book Runners as Stabilising Agent, who will be responsible for the price stabilisation process.

(2) The stabilising agent is allowed to borrow shares (against a fee) from the promoters or the pre-issue shareholders or both upto a maximum of 15% of the issue size. In case of a listed company, a lender must hold more than 5% of the shares.

(3) These shares must be in dematerialised form.

(4) The stabilising agent allocates these shares on pro-rata basis to different categories of bidders.

(5) If there is a downward trend after the shares get listed, the stabilising agent buys shares from the market to ensure that the price does not fall below the issue price. The number of shares purchased shall not exceed the over-allotted shares. Moreover, once purchased, these shares cannot be sold back in the market.

(6) The stabilising mechanism is available for the period disclosed by the company in the prospectus, which shall not exceed 30 days from the date when trading permission was given by the stock exchanges.

(7) The stabilising agent has to open a GSO Bank Account where the money received from issue of additional shares is kept. These funds have to be used by the stabilising agent to buy shares from the market.

(8) The stabilising agent has to open a GSO Demat Account for the shares bought from the market. These shares have to be refunded to the lender(s) within 2 days after the close of the stabilisation period.

(9) On expiry of the stabilisation period, if the stabilising agent does not buy shares to the extent over allotted, the issuer company shall allot fresh shares to the lenders in dematerialised form to cover the shortfall within 6 days from the expiry of the stabilisation period.

(10) The stabilising agent shall remit an amount equal to (additional shares allotted by the company X issue price) to the company from the GSO Bank Account. An amount left in the account shall be transferred to the Investor Protection Fund of the stock exchanges. The GSO Demat Account shall be closed after returning the shares to the lender.

2

Accounting for Bonus and Rights Issue

Bonus Shares

Introduction

Bonus shares are shares issued by a company free of cost to its existing shareholders on a pro-rata basis. A company that has built up substantial reserves sometimes decides to capitalise a part of these reserves by issuing bonus shares to existing shareholders, without the shareholders having to pay anything. All successful companies increase their capital base by giving free shares to its existing shareholders from the reserves when there are large accumulated reserves which cannot, either by law or as a matter of financial prudence, be distributed as dividends in cash to shareholders. Since bonus shares are created by the conversion of retained earnings or other reserves into equity share capital, issue of bonus shares does not represent a ***source of fund*** to the company. It means that there is no inflow of cash.

When bonus shares are given, the 'Shareholders' Funds' does not change and, ***the assets section of the Balance Sheet remains unaffected***. On the 'Equity and Liabilities' section, the reserves are ***reduced*** by the amount of the ***increase*** in the equity share capital. Reserves capitalised in this way no longer become available for distribution as dividends. In principle, shareholders are primarily no better-off as a result of bonus issue, though no cash is paid to acquire these shares. This is because the total value of the company remains unaffected, although the number of shares held by a shareholder is increased by a bonus issue.

For example, a company has the following capital structure :

	₹
1,00,000 Equity Shares of ₹ 10 each	10,00,000
Securities Premium Account	1,00,000
Profit and Loss Account	5,00,000

The company decides to make a bonus issue on 1 for 4 basis (the shareholders will receive one new share for every four existing shares they own) by making use of Securities Premium Account and Profit and Loss Account. Therefore, the company requires ₹ 2,50,000 (₹ 1,00,000 from Securities Premium Account and ₹ 1,50,000 from Profit and Loss Account) to issue 25,000 bonus shares of ₹ 10 each (1/4th of existing 1,00,000 shares).

After the bonus issue, the capital structure of the company will appear as below :

	₹
1,25,000 Equity Shares of ₹ 10 each	12,50,000
Profit and Loss Account	3,50,000

After the issue of bonus shares, the market price of share will drop initially depending upon the bonus ratio. Research studies have concluded that the reduction in actual market price is not exactly in proportion to the size of the bonus issue. For a 3 : 1 bonus issue, the ex-bonus market price would definitely not become one-fourth of its current price.

A bonus issue has two implications :

First, it increases the number of shares available for trade.

Second, it signals the management's confidence in accelerating or at least maintaining the profit growth. This is because, while nothing may have changed for the shareholders, the company has to henceforth pay cash dividend on a higher equity base. Therefore, it is has to generate more cash in the future. The signal is, therefore, stronger.

Objects of Bonus Shares Issue

Bonus shares are issued by a company for the following reasons :

1. The management may opt for an issue of bonus shares in order to increase the paid-up capital.
2. By issue of bonus shares the cash resources of the company are conserved. When a new project is under implementation which may take a few years to start giving increasing returns, it may be prudent to wait till the project is completed and increased returns start coming.
3. Issue of bonus shares will reduce the chance of take-over bids.
4. Issue of bonus shares is an indication to the investors that the company has good prospects.
5. Issue of bonus shares is an inexpensive method of raising capital base of the company.
6. Issue of bonus shares reduces the market price of the shares, thus rendering them more marketable.
7. It indicates management's confidence in the future earning potential of the firm.
8. To make stock options more attractive and retain the good talent.

Advantages of the Issue of Bonus Shares

The following are the advantages of issue of bonus shares :

1. Bonus shares help unlock shareholders' wealth. The shareholders get back their undistributed profit in the shape of shares.
2. Company can keep its shareholders happy without impairing the financial position and liquidity of the company.
3. The security of the creditors will increase owing to increase in share capital.
4. It will increase the number of shares in the hands of existing shareholders without any extra payment, thus it will increase the marketability of shares.
5. No tax is payable by the company or the shareholder.

Disadvantages of the Issue of Bonus Shares

The following are the disadvantages of issue of bonus shares :

1. Issue of bonus shares would increase the cash dividend for the future. Therefore, the rate of dividend in future will decline sharply, which may create confusion in the minds of the investors.
2. It will encourage speculative dealings in the company's shares.
3. Prior approval of the SEBI must be obtained before the bonus issue. The lengthy procedures, sometimes, may delay the issue of bonus shares.
4. Earning Per Share (EPS) will fall if there is no corresponding increase in earnings.

Issue of Bonus Share Under Companies Act, 2013

In the Companies Act, 1956, there was no specific provision for issue of bonus shares. At that time, the SEBI Guidelines / Regulations used to govern the issue of bonus shares. However, the Companies Act, 2013 has provided Section 63 for issue of bonus shares. This section states that :

(1) A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—
(i) its free reserves;
(ii) the securities premium account; or
(iii) the capital redemption reserve account.
Provided that no issue of bonus shares shall be made by capitlising reserves ***created by the revaluation of assets***.

(2) No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless—
(a) it is authorised by its articles;
(b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;
(c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
(d it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
(e) the partly paid-up shares, if any, outstanding on the date of allotment, are made fully paid-up;
(f) it complies with such conditions as may be prescribed.

(3) The bonus shares shall not be issued in lieu of dividend.

It is to be noted that a ***listed*** company, in addition to the above provisions, shall also be required to comply with the ***SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009****. It provides that a listed issuer may issue bonus shares to its members if :

(a) it is authorised by its articles of association for issue of bonus shares, capitalisation of reserves, etc.
Provided that if there is no such provision in the articles of association, the issuer shall pass a resolution at its general body meeting making provisions in the articles of associations for capitalisation of reserve;
(b) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
(c) it has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribyution to provident fund, gratuity and bonus;
(d) the partly paid shares, if any outstanding on the date of allotment, are made fully paid-up.

Restriction on Bonus Issue

(1) No issuer shall make a bonus issue of equity shares unless it has made ***reservation of equity shares*** of the same class in favour of the holders of outstanding compulsorily convertible debt instruments, if any, in proportion to the convertible part thereof.

(2) The equity shares so reserved for the holders of fully or partly convertible debt instruments shall be issued at the time of conversion of such convertible debt instruments on the same terms or same proportion at which the bonus shares were issued.

Bonus Shares only against Reserves, etc. if Capitalised in Cash

(1) The bonus issue shall be made out of free reserves built ***out of the genuine profits*** or securities premium ***collected in cash only*** and reserves created by revaluation of fixed assets shall not be capitalised for the purpose of issuing bonus shares.

(2) Without prejudice to the provisions of sub-regulation (1), the bonus share shall not be issued in lieu of dividend.

* As amended upto 25th April, 2015

Completion of Bonus Issue

(1) An issuer, announcing a bonus issue after the approval of its board of directors and not requiring shareholders' approval for capitalisation of profits or reserves for making the bonus issue, shall implement the bonus issue ***within fifteen days*** from the date of approval of the issue by its board of directors;

Provided that where the issuer is required to seek shareholders' approval for capitalisation of profits or reserves for making the bonus issue, the bonus issue shall be implemented ***within two months from the date of the meeting of its board of directors wherein the decision to announce the bonus issue was taken subject to shareholders' approval***.

(2) Once the decision to make a bonus issue is announced, the issue ***can not be withdrawn.***

List of Companies Issued Bonus Shares in the Last Six Months of 2014-15

Name of the Company	Ratio of Bonus	Date of Announcement	Record Date
Chankya Investment Ltd.	3 : 1	19-03-2015	06-05-2015
Insecticides Ltd.	1 : 2	30-10-2015	17-04-2015
Piccadilly Agro Ltd.	1 : 1	16-02-2015	07-04-2015
VHCL Industries Ltd.	3 : 1	18-02-2015	27-03-2015
Va Tech Wabag Ltd.	1 : 1	07-02-2015	27-03-2015
Aarti Drugs Ltd.	1 : 1	30-01-2015	25-03-2015
Tech Mahindra Ltd.	1 : 1	30-01-2015	20-03-2015
HCL Tech Ltd.	1 : 1	30-01-2015	20-03-2015
Rai Saheb Mills Ltd.	1 : 6	05-02-2015	17-03-2015
Aarya Global Ltd.	3 : 4	23-08-2014	12-03-2015
Persistent Ltd.	1 : 1	24-01-2015	11-03-2015
SVP Global Ltd.	9 : 1	20-01-2015	05-03-2015
Finotex Chemical Ltd.	1 : 1	15-12-2014	13-02-2015
Trilogic Digi Ltd.	1 : 1	29-05-2014	12-02-2015
Delton Cables Ltd.	2 : 1	12-12-2014	27-01-2015
SRS Real Infra Ltd.	1 : 1	18-11-2014	14-01-2015
Godrej Industries Ltd.	1 : 1250	07-02-2014	06-01-2015
Minda Corporation Ltd.	1 : 1	14-11-2014	06-01-2015
JMD Telefilms Ltd.	1 : 1	24-11-2014	02-01-2015

Sources of Bonus Issue

Bonus shares can be paid out of (i) free reserves; (ii) securities premium; and (iii) capital redemption reserve. The Companies Act has not given the order in which the different sources (as mentioned above) will be utilised for issue of bonus shares.

It is worth noting that Capital Redemption Reserve can be used only for issuing fully paid-up bonus shares (Section 55(3) of the Companies Act, 2013). Therefore, it is logical to use ***CRR in first***.

Securities Premium can also be used for issuing bonus shares. However, there is a condition that it must be ***collected in cash***. In many cases shares are issued at a premium at the time of acquiring some assets.

The following entry is passed for acquisition of the assets :

Assets Account Dr.

To Equity Share Capital Account

To Securities Premium Account

In this case, 'Securities Premium' has not been received in cash. Therefore, it can not be used for bonus issue.

Free reserves can also be used for issue of bonus shares. Section 2(43) of the Companies Act, 2013 has defined 'Free Reserves' as follows :

"Free reserves means such reserves which as per the ***latest audited*** Balance Sheet of a company, are available for distribution as dividend :

Provided that—

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whatever shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in Profit and Loss Account on measurement of the asset or the liability at fair value;

shall not be treated as free reserves."

Prior Action Regarding Bonus Issue

1. The Board of Directors will fix the Record Date and inform the Stock Exchange 42 days in advance.
2. The approval of the regional office of the RBI must be obtained before allotment of bonus shares to non-resident shareholders.
3. A general notice shall be given as per the provisions of the Companies Act, 2013.

Points to be Noted

1. Partly paid-up shares, if any, are to be made fully paid-up before allotment of bonus shares.
2. Bonus shares can be issued in the ratio more than 1 :1. (See the list of companies in the previous page).
3. Capital Redemption Reserve shall be used first.
4. Securities Premium not collected in cash can not be used for issuing of bonus shares.
5. Bonus shares shall not be issued in lieu of dividend.
6. No issue of bonus shares shall be made out of reserves created by the revaluation of the assets.
7. It makes no sense to issue bonus shares at a premium. In practice, no company is doing this.

Accounting Entries

(a) Capital Redemption Reserve Account Dr.
Securities Premium Account Dr.
Other Reserves Account etc. Dr.
To Bonus to Shareholders Account

(b) Bonus to Shareholders Account Dr.
To Equity Share Capital Account

Illustration 1

Jayanti Ltd. has an authorised capital of ₹ 8,00,000 in equity shares of ₹ 100 each of which 4,000 shares were issued to the public in 2010. It is decided on 1st April, 2017 that 1,000 unissued shares are to be issued to the existing shareholders as fully paid bonus shares and a part of the company's Reserve Fund amounting to ₹ 5,00,000 should be utilised in this connection. You are required to give journal entries, recording the above transactions related to bonus issue.

Solution

In the books of Jayanti Ltd.
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2017 April 1	Reserve Fund A/c Dr. To Bonus to Shareholders A/c (Being bonus declared out of Reserve Fund as per Board's Resolution No. ... dated ... as confirmed by general meeting resolution no. ... dated ...)	1,00,000	1,00,000
?	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Being issue of 1,000 equity shares of ₹ 100 each as per Board's Resolution No. ... dated ...)	1,00,000	1,00,000

Illustration 2

A limited company with a subscribed capital of ₹ 10,00,000 in equity shares of ₹ 10 each has resolved to utilise the balance of Securities Premium Account to issue fully paid bonus shares in the ratio of one equity share for every five equity shares held.

Show journal entries in the books of the company.

Solution

The number of equity shares of the company = ₹ 10,00,000 ÷ 10 = 1,00,000 shares.

One bonus shares will be given for every five shares held. Therefore, total number of bonus shares will be :

$\frac{1,00,000}{5} \times 1$ = **20,000 shares**

Amount of bonus = 20,000 × ₹ 10 = ₹ **2,00,000.**

In the books of the Company
Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Securities Premium A/c Dr.	2,00,000	
	To Bonus to Shareholders A/c		2,00,000
	(Being bonus declared out of Securities Premium as per Board's Resolution No. ... dated ... as confirmed by general meeting resolution no. ... dated ...)		
	Bonus to Shareholders A/c Dr.	2,00,000	
	To Equity Share Capital A/c		2,00,000
	(Being issue of 20,000 equity shares of ₹ 10 each as per Board's Resolution No. ... dated ...)		

Illustration 3

Balance Sheet of X Co. Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,50,000
(b) Reserves and Surplus	(2)	1,25,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		25,000
TOTAL		3,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant and Machinery		1,80,000
(ii) Intangible Assets — Goodwill		10,000
(2) Current Assets :		
(a) Current Investments		10,000
(b) Inventories		50,000
(c) Trade Receivables		40,000
(d) Cash and Cash Equivalents		10,000
TOTAL		3,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
25,000 Equity Shares of ₹ 10 each	2,50,000
Issued, Subscribed and Paid-up Capital :	
15,000 Equity Shares of ₹ 10 each fully paid	1,50,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	20,000
General Reserve	60,000
Profit and Loss Account	45,000
	1,25,000

On 1st April, 2017, the company in its general meeting decided to issue bonus shares at the ratio of 2 : 5. It was also decided to utilise the following for this purpose :

(i) Securities premium to the full extent.

(ii) ₹ 20,000 out of general reserves.

(iii) Balance out of Profit and Loss Account.

Give journal entries to incorporate the above decisions.

Solution

The ratio of bonus shares is 2 : 5. It means 2 bonus shares will be given for 5 shares held. Therefore, total number of bonus shares will be issued :

$\frac{15,000}{5} \times 2 = 6,000$ shares.

(a) Amount required for bonus issue = 6,000 × ₹ 10 - **60,000.**

(b) Amount to be utilised :

Securities Premium	20,000	
General Reserve	20,000	
Profit and Loss (Balancing figure)	20,000	**60,000**

In the books of X Co. Ltd.
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017	Securities Premium A/c	Dr.	20,000	
April 1	General Reserve A/c	Dr.	20,000	
	Profit and Loss A/c	Dr.	20,000	
	To Bonus to Shareholders A/c			60,000
	(Being bonus declared out of Securities Premium, General Reserve and Profit and Loss Account as per Board's Resolution No. ... dated ... as confirmed by general meeting resolution no. ... dated ...)			
	Bonus to Shareholders A/c	Dr.	60,000	
	To Equity Share Capital A/c			60,000
	(Being issue of 6,000 equity shares of ₹ 10 each as per Board's Resolution No. ... dated ...)			

Illustration 4

The following was the Balance Sheet of Abhishek Cosmetics Ltd as on 31st March, 2017.

Balance Sheet of Abhishek Cosmetics Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus	(2)	3,30,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		90,000
TOTAL		8,20,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		8,20,000
(2) Current Assets :		—
TOTAL		8,20,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
50,000 Equity Shares of ₹ 10 each	5,00,000
Issued, Subscribed and Paid-up Capital :	
40,000 Equity Shares of ₹ 10 each fully paid	4,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	1,40,000
General Reserve	70,000
Profit and Loss Account	1,20,000
	3,30,000

The company issued one bonus share for every four fully paid-up shares. Securities Premium Account will be utilised first. Show Journal Entries and Balance Sheet.

Solution

In the books of Abhishek Cosmetics Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
?	Securities Premium A/c	Dr.	1,00,000	
	To Bonus to Shareholders A/c (Note 1)			1,00,000
	(Being the declaration of bonus in the ratio of 1 : 4 as per Board's Resolution No. ... dated ... as confirmed by General Meeting resolution No. ... dated ...)			
?	Bonus to Shareholders A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Being issue of 10,000 equity shares of ₹ 10 each as bonus as per Board's Resolution No. ... dated ...)			

Balance Sheet of Abhishek Cosmetics Ltd. as at 31st March , 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus	(2)	2,30,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		90,000
TOTAL		8,20,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		8,20,000
(2) Current Assets :		—
TOTAL		8,20,000

Note : (1) One bonus share will be given for every four shares held. Therefore, number of bonus shares = 40,000 / 4 = **10,000 shares**.

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
50,000 Equity Shares of ₹ 10 each	5,00,000
Issued, Subscribed and Paid-up Capital :	
50,000 Equity Shares of ₹ 10 each (including 10,000 shares issued as bonus)	5,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	40,000
General Reserve	70,000
Profit and Loss Account	1,20,000
	2,30,000

Illustration 5

The Balance Sheet of Kartik Ltd. as on 31st March, 2015 is given below :

Balance Sheet of Kartik Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus — General Reserve		5,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		2,00,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		20,00,000
(b) Trade Payables		20,00,000
(c) Other Current Liabilities		5,00,000
(d) Short-term Provisions		—
TOTAL		62,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(2)	27,50,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		4,50,000
(b) Inventories		5,00,000
(c) Trade Receivables		10,00,000
(d) Cash and Cash Equivalents		5,00,800
(e) Short-term Loans and Advances		5,00,000
(f) Other Current Assets		5,00,000
TOTAL		62,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
2,00,000 Equity Shares of ₹ 10 each	20,00,000
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each	10,00,000

(2) Fixed Assets

Particulars	₹
(a) *Tangible Assets* :	
Land and Building	7,50,000
Plant and Mchinery	12,00,000
Furniture and Fittings	8,00,000
	27,50,000

At the shareholders' meeting on 1st July,2017 of the company it was decided to adopt the following schemes :

(i) The authorised capital was increaesd to 2,50,000 equity shares of ₹ 10 each.

(ii) A bonus issue was made to the existing shareholders, at the ratio of two fully paid-up equity shares of ₹ 10 each for every five shares held.

You are required to pass necessary journal entries and show the Balance Sheet.

Solution

Number of Bonus Shares to be issued = $\frac{1,00,000}{5} \times 2 = \textbf{40,000 Equity Shares}$

In the books of Kartik Ltd
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2017 July 1	General Reserve A/c Dr.	4,00,000	
	To Bonus to Shareholders A/c		4,00,000
	(Being the declaration of bonus in the ratio of 2 : 5 as per Resolution No. ... dated ...)		
	Bonus to Shareholders A/c Dr.	4,00,000	
	To Equity Share Capital A/c		4,00,000
	(Being the issue of 40,000 equity shares as bonus as per Board's Resolution No. ... dated...)		

Balance Sheet of Kartik Ltd. as at 1st July, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	14,00,000
(b) Reserves and Surplus	(2)	1,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		2,00,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		20,00,000
(b) Trade Payables		20,00,000
(c) Other Current Liabilities		5,00,000
(d) Short-term Provisions		—
TOTAL		62,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	27,50,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—

(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		4,50,000
(b) Inventories		5,00,000
(c) Trade Receivables		10,00,000
(d) Cash and Cash Equivalents		5,00,000
(e) Short-term Loans and Advances		5,00,000
(f) Other Current Assets		5,00,000
TOTAL		62,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
2,50,000 Equity Shares of 10 each	25,00,000
Issued, Subscribed and Paid-up Capital :	
1,40,000 Equity Shares of ₹ 10 each fully paid (Out of the above, 40,000 equity shares have been issued as bonus shares)	14,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve (5,00,000 – 4,00,000)	1,00,000

Illustration 6

The Balance Sheet of A Limited as at 31.3.2017 is as follows :

Balance Sheet of A Limited as at 31st March, 2017.

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,00,000
(b) Reserves and Surplus — General Reserve	(2)	11,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		3,00,000
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		20,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		17,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		1,00,000
(d) Cash and Cash Equivalents		2,00,000
TOTAL		20,00,000

Notes to Accounts :

(1) Share Capital | **(2) Reserve and Surplus**

Particulars	₹	Particulars	₹
Authorised Capital :		Capital Redemption Reserve	1,50,000
1,50,000 Equity Shares of 10 each	15,00,000	Plant Revaluation Reserve	20,000
Issued, Subscribed and Paid-up Capital :		Securities Premium (₹ 50,000 was not received in cash)	1,50,000
80,000 Equity Shares of ₹ 10 each, ₹ 7.50 paid-up	6,00,000	Development Rebate Reserve	2,30,000
		Investment Allowance Reserve	2,50,000
		General Reserve	3,00,000
			11,00,000

The Company wanted to issue bonus shares to its shareholders @ one share for every two shares held. Necessary resolutions were passed; requisite legal requirements were complied with.

You are required to :

(a) Give effect to the proposal by passing Journal Entries in the books of A Ltd on 1st April, 2017;

(b) Show the amended Balance Sheet.

Solution

In the books of A Ltd
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017	Equity Share Final Call A/c [**See Tutorial Note**]	Dr.	2,00,000	
April 1	To Equity Share Capital A/c			2,00,000
	(Being the final call money due on 80,000 shares @ ₹ 2.50 per share as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	2,00,000	
	To Equity Share Final Call A/c			2,00,000
	(Being the final call money received for 80,000 shares)			
	Capital Redemption Reserve A/c	Dr.	1,50,000	
	Securities Premium A/c [**See Tutorial Note**]	Dr.	1,00,000	
	General Reserve A/c	Dr.	1,50,000	
	To Bonus to Shareholders A/c			4,00,000
	(Being 1 bonus share payable for 2 shares held as per Shareholders' Resolution No. ... dated ...)			
	Bonus to Shareholders A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being issue of 40,000 shares of ₹ 10 each as bonus as per Board's Resolution No. ... dated ...)			

Balance Sheet of A Ltd. as at 1st April, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,00,000
(b) Reserves and Surplus	(2)	7,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—

(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		3,00,000
(c) Other Current Liabilities		—
TOTAL		22,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		17,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		1,00,000
(d) Cash and Cash Equivalents		4,00,000
TOTAL		22,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
1,50,000 Equity Shares of 10 each	15,00,000
Issued, Subscribed and Paid-up Capital :	
1,20,000 Equity Shares of ₹ 10 each fully paid	12,00,000
(Out of the above, 40,000 equity shares have been issued as bonus shares)	

(2) Reserve and Surplus

Particulars	₹
Plant Revaluation Reserve	20,000
Development Rebate Reserve	2,30,000
Investment Allowance Reserve	2,50,000
Securities Premium	50,000
General Reserve	1,50,000
	7,00,000

Tutorial Notes

(1) First, all partly paid-up equity shares (₹ 7.50 paid-up) are to be made fully paid-up.
(2) Securities Premium to the extent of ₹ 50,000 can not be used for issuing bonus shares as it was not received in cash.

Illustration 7

The following is the abstract of Balance Sheet of Bharat Shoe Co. Ltd. as on 31st March, 2017 :

		₹
Issued and Paid-up Capital :		
45,000 Equity Shares of ₹ 10 each fully paid-up	4,50,000	
Less: Calls-in-arrear (5,000 Equity Shares of ₹ 2 each)	10,000	4,40,000
20,000 Equity Shares of ₹ 10 each, ₹ 4 cash paid-up		80,000
Reserves and Surplus :		
Capital Reserves (realised in cash)		30,000
Capital Redemption Reserve		80,000
Securities Premium		50,000
Dividend Equalisation Reserve		30,000
General Reserve		30,000
Profit and Loss Account		3,50,000

On 1st April, 2017, the Board of Directors of the company decided :
(a) to forfeit the shares on which final call of ₹ 2 each is due;
(b) to re-issue the forfeited shares @ ₹ 12 each as fully paid-up;
(c) to issue fully paid bonus shares@ one fully paid bonus shares for every two fully paid shares held; and
(d) to use minimum balance of Profit and Loss Account.
Pass necessary journal entries in the books of the company on the basis of the above decisions.

Solution

Section 63(2)(e) of the Companies Act, 2013 states that :

"the partly paid-up shares, if any, outstanding on the date of allotment, are made fully paid-up."

20,000 equity shares of ₹ 10 each are partly paid-up. Therefore, all these share are to be converted into fully paid-up by making final call @ ₹ 6 each.

Solution

In the books of Bharat Shoe Co. Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 April 1	Equity Share Final Call A/c	Dr.	1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Being the final call money @ ₹ 6 per share is payable as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	1,20,000	
	To Equity Share Final Call A/c			1,20,000
	(Being the final call money received for 20,000 shares @ ₹ 6 each)			
	Equity Share Capital A/c	Dr.	50,000	
	To Calls-in-Arrear A/c			10,000
	To Forfeited Shares A/c			40,000
	(Being the forfeiture of 5,000 equity shares of ₹ 10 each for non-payment of ₹ 2 per share as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	60,000	
	To Equity Share Capital A/c			50,000
	To Securities Premium A/c			10,000
	(Being re-issue of 5,000 equity shares @ ₹ 12 each as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c	Dr.	40,000	
	To Capital Reserve A/c			40,000
	(Being the profit on re-issue transferred to Capital Reserve)			
	Capital Redemption Reserve A/c	Dr.	80,000	
	Securities Premium A/c (50,000 + 10,000)	Dr.	60,000	
	Capital Reserve A/c (30,000 + 40,000)	Dr.	70,000	
	Dividend Equalisation Reserve A/c	Dr.	30,000	
	General Reserve A/c	Dr.	30,000	
	Profit and Loss A/c	Dr.	55,000	
	To Bonus to Shareholders A/c (Note 1)			3,25,000
	(Being the declaration of bonus in the ratio of 1 : 2 as per Board's Resolution No. ... dated ... as confirmed in Shareholders' Meeting No. ... dated ...)			
	Bonus to Shareholders A/c	Dr.	3,25,000	
	To Equity Share Capital A/c			3,25,000
	(Being the issue of 32,500 equity shares of ₹ 10 each as per Board's Resolution No. ... dated ...)			

Working Note :

(1) Total Number of Shares = 45,000 + 20,000 = 65,000.

One bonus shares will be issued for every two shares held. Therefore, number of bonus shares issued =

$$\frac{65,000}{2} \times 1 = 32,500 \text{ shares.}$$

Amount of bonus = 32,500 × 10 = ₹ **3,25,000**.

Illustration 8

Balance Sheet of Jayanti Limited as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus — General Reserve	(2)	11,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		

(3) Non-current Liabilities :		
(a) Long-term Borrowings		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		80,000
(b) Trade Payables		2,00,000
(c) Other Current Liabilities		—
TOTAL		22,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	15,00,000
(ii) Non-current Investments		2,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		80,000
(c) Trade Receivables		2,00,000
(d) Cash and Cash Equivalents		3,00,000
TOTAL		22,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
3,000 Preference Shares of ₹ 100 each	3,00,000
	18,00,000
Issued, Subscribed and Paid-up Capital :	
80,000 Equity Shares of ₹ 10 each, ₹ 7.50 fully paid-up	6,00,000
2,000, 9% Preference Shares of ₹ 100 each fully paid-up	2,00,000
	8,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve	1,50,000
Plant Revaluation Reserve	20,000
Securities Premium Account	1,50,000
Development Rebate Reserve (free reserves)	2,30,000
Investment Allowance Reserve	2,50,000
General Reserve	3,00,000
	11,00,000

(3) Fixed Assets

(a) *Tangible Assets*	
Land	8,00,000
Plant	5,00,000
Machinery	2,00,000
	15,00,000

On 1st April, 2017, the company resolved that :

(i) All partly paid-up shares to be called-up.

(ii) 9% Preference Shares of ₹ 100 each will be converted into 10% Preference Shares of ₹ 100 each, fully paid in a manner so that the return on the preference shares remain same and to make good the difference by issue of necessary equity shares of ₹ 10 each fully paid-up.

(iii) To issue bonus shares to equity shareholders (excluding shares issued on conversion of preference shares) in the ratio of one share for every two shares held.

You are required to pass necessary journal entries to give effect to the above.

Solution

Number of 9% Preference Shares = 2,000. Amount of dividend = 2,000 × ₹ 9 = ₹ 18,000.

On the new preference shares, the rate of dividend is 10%. Therefore, the face value of preference shares to be issued to get same amount of dividend =

$$\frac{18,000}{10} \times 100 = ₹\ \mathbf{1,80,000}.$$

	₹
Face value of 9% Preference Shares	2,00,000
Face value of 10% New preference shares	1,80,000
Shortfall	20,000

This shortfall will be covered by issuing equity shares of ₹ 10 each fully paid.

Number of equity shares to be issued = ₹ 20,000 ÷ ₹ 10 = **2,000 equity shares**.

In the books of Jayanti Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 April 1	Equity Share Final Call A/c	Dr.	2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Being the final call money @ ₹ 2.50 per share is payable on 80,000 equity shares as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	2,00,000	
	To Equity Share Final Call A/c			2,00,000
	(Being the final call money received for 80,000 shares @ ₹ 2.50 each)			
	9% Preference Share Capital A/c	Dr.	2,00,000	
	To 10% Preference Share Capital A/c			1,80,000
	To Equity Share Capital A/c			20,000
	(Being the conversion of 2,000, 9% Preference Shares of ₹ 100 each into 1,800, 10% Preference Shares of ₹ 100 each. The balance amount was paid by issue of 2,000 equity shares of ₹ 10 each as per Board's Resolution No. ... dated ...)			
	Capital Redemption Reserve A/c	Dr.	1,50,000	
	Securities Premium A/c	Dr.	1,50,000	
	Development Rebate Reserve A/v	Dr.	1,00,000	
	To Bonus to Shareholders A/c			4,00,000
	(Being the declaration of bonus in the ratio of 1 : 2 as per Board's Resolution No. ... dated ... as confirmed in Shareholders' Meeting No. ... dated ...)			
	Bonus to Shareholders A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being the issue of 40,000 equity shares of ₹ 10 each as bonus as per Board's Resolution No. ... dated ...)			

Bonus Debentures

Introduction

Bonus Debentures are debentures issued by a company to its existing shareholders ***free of cost***. These debentures carry normal rate of interest and these are redeemed after a certain period. Bonus debentures are issued out of accumulated reserves.

In India, bonus debentures were first issued by Hindustan Lever Limited in 2001. Till today, only seven other companies have issued bonus debentures. Very recently (in December 2014), NTPC Ltd. has approved the issuance of bonus debentures of face value of ₹ 12.50 each for every equity share of ₹ 10. The interest to be paid @ 8.49 p.a. payable annually. [For details, see '***Real Life Focus***' in the next page.]

Bonus debentures are generally listed on a recognised stock exchange. The bonus debentureholders can sell it for immediate cash.

Distinction between Bonus Shares and Bonus Debentures

	Bonus Shares		Bonus Debentures
1.	It is issued from accumulated reserve and surplus. After issue of bonus shares, there is no change in equity. Therefore, debt-equity ratio remains the same.	1.	It is issued from accumulated reserve and surplus. But, after issue of bonus debentures, there is a change in equity. Equity is converted to debt. Therefore, the debt-equity ratio will increase.
2.	When bonus shares are issued, there is no cash inflow or outflow.	2.	When bonus debentures are issued, there is immediate outflow of cash by way of dividend distribution tax.

3.	Cash divided is paid like other shares. No tax benefit is available to the company for dividend paid.	3.	Fixed rate of interest is paid annually. However, such interest will be allowed as deduction at the time of calculation of taxable income of the company.
4.	In the Companies Act, 2013, there is a specific provision for issue of bonus shares. [Sec. 63]	4.	In the Companies Act, 2013 there is no specific provision for issue of bonus debentures.
5.	The issue of bonus shares will reduce the Earning per Share (EPS) as number of shares increases.	5.	The issue of bonus debentures will not reduce the Earning per Share (EPS) as there is no change in the number of shares.
6.	There will be no change in 'Return on Equity' after the issue of bonus shares as equity will remain same.	6.	The 'Return on Equity' will improve after the issue of bonus debentures as equity will reduce.
7.	The inventors will not have to pay income tax on dividend received.	7.	The investors will have to pay income tax on interest received from bonus debentures.
8.	Process of issue of bonus shares is very simple. Provision in the articles of association and approval of shareholders are sufficient.	8.	The process of issue of bonus debentures is cumbersome. The approval from Shareholders, Tribunal, RBI, etc. are necessary and is, therefore, time consuming.

Real Life Focus

NTPC Ltd. Become First PSU to Issue Bonus Debentures

The Government of India receives 618 crore bonus debentures amounting to ₹ 7725.76 crore by virtue of its 74.96% shareholding in NTPC Ltd. In addition to the bonus debentures, the Government of India has also received ₹ 2060.75 crore as dividend distribution tax on the debentures.

NTPC Ltd has earlier issued, by way of bonus, one fully paid-up secured debenture of ₹ 12.50 each for every one fully paid-up equity share of ₹ 10 each held by its members. The issue size of the bonus debenture is of ₹ 10306.83 crore and is also the biggest issue of its kind in the country and also the first ever by any PSU. The bonus debentures carries the coupon rate of 8.49% p.a. payable annually and has been allotted.

The need for issuing bonus debentures was felt sometime in July / August 2014. As on 31st March 2014, the company had free reserves of over ₹ 72000 crores and a cash balance of ₹ 15300 crore. Since the Company is in regulated generation business, there is little room for improvement of profitability. High net worth of around ₹ 85000 crore depresses ROE which works out to only around 12.78% on reported basis. Thus there was a need for capital optimisation.

Since the company has entered in its 40th year of incorporation, there was no better way to reward the shareholders than issuing bonus debentures.

Key Features of Transaction :

- ***This was the largest ever Bonus Debenture issue of ₹ 10,307 crore in India.***
- ***The issue created the largest Debentureholders base on 7,01,102 investors thus adding depth to debt market.***
- ***The transaction was executed in shortest possible time of 93 days from Board Approval to Allotment as against 12-36 months by other issuers.***
- ***NTPC becomes the first PSU and First Maharatna to undertake such innovative capital restructuring exercise.***
- ***Seamless co-ordination amongst Ministry of Power, Ministry of Corporate Affairs, Ministry of Finance and team NTPC.***
- ***Government of India has received 618 crore bonus debentures of ₹ 7,726 crore of face value.***

Source : Press Information Bureau, Govt. of India, Ministry of Finance

Rights Share / Further Issue of Capital

Introduction

Public issue of shares is an expensive and risky process of raising finance. It is time consuming and complex. A rights issue is a cheap and faster way of raising finance. It is an issue of shares in which the existing shareholders have a pre-emptive right to subscribe for the new shares. In a rights issue, ***no prospectus is issued*** or offer for sale of shares is made; instead, existing equity shareholders are given '***Letter of Offer and Application Form***' in proportion to the existing holding which entails them to take up a specified number of shares at a specified price. The price of the shares so offered is usually below listed price to make the offer attractive. The reason for fixing the rights price at a discount to the current market price is that shareholders need encouragement to subscribe for ***extra shares***. If a company wishes to raise more money, then it can attempt to issue a greater number of shares through the rights issue. An existing shareholder who does not wish to exercise any or all of the rights is at liberty to sell them to third parties who can purchase such shares at a specified price. ***Alternatively***, shareholders may renounce their rights in favour of the company which may sell the shares to the public in such a manner as the Board of Directors think most beneficial to the company.

Where a rights issue would result in an awkward fraction, some shareholders may be entitled to a fraction of a share. In such a case, the company may either round it off or may issue fractional rights share coupons. The shareholders, entitled to the fractions, is required to buy a number of coupons and will have to submit them to the company for getting a rights share.

It should be noted that there are two main reasons for a company to come out with a rights issue. First reason is that a rights issue may be the only way of raising finance when the company is in need of cash to carry out existing operations. Second reason is to retain shareholding pattern same as before.

For example, in the first five months of 2015 different Indian Comapnies (e.g., Tata Motors, GMR Intra Ltd., CanFin Home Ltd., etc.) have raised ₹ 11,500 crore from rights issue.

Share prices of the company are likely to fall since the same amount of profit will be distributed to more number of shareholders. If the company needs the finance for profitable investment and issue of rights share is the answer to the external financial requirement, then the share price is likely to rise. On the other hand, if it appears that the expansion will generate the same rate of return as existing operations, the market price of the shares will be unaffected. In many cases, ***financially stressed*** companies typically use rights issue to pay off high cost debts, particularly, when market condition is not good for public issue or the company is unable to borrow money at a moderate rate.

The accounting entries in the books of the company for a rights issue are the same as those required for a new issue of shares to the public. There is only one exception — ***the existing shareholders know in advance the number of shares to which they will be entitled***. In this connection, the provision of Section 62 of the Companies Act, 2013 is relevant. The section is reproduced below:

Section 62 of the Companies Act, 2013 govern the issue of rights shares. This section states that

(1) Where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered—

- (a) to persons who, at the date of the offer, are holders of equity shares of the company in proportion, as nearly as circumstances admit, to the paid-up share capital on those shares by sending a letter of offer subject to the following conditions, namely—
  - (i) the offer shall be made by notice specifying the number of shares offered and limiting a time not being less than ***fifteen days*** and not exceeding ***thirty days*** from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;
  - (ii) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (i) shall contain a statement of this right;

(iii) after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company;

(b) to employees under a scheme of employees' stock option, subject to special resolution passed by company and subject to such conditions as may be prescribed, or

(c) to any persons, if it is authorised by a special resolution, whether or not those persons include the persons referred to in clause (a) or clause (b), either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer subject to such conditions as may be prescribed.

(2) The notice shall be despatched through registered post or speed post or through electronic mode to all the existing shareholders at least ***three days*** before the opening of the issue.

SEBI Regulations Regarding Rights Issue*

This regulation [SEBI (Issue of Capital and Disclosure Requirements) Regulations] is applicable ***to listed companies*** who are interested to issue rights shares to their existing equity shareholders. The different regulations are stated below :

Record Date**

(1) A listed issuer making a rights issue shall announce a record date for the purpose of determining the shareholders eligible to apply for specified securities in the proposed rights issue.

(2) The issuer shall not withdraw rights issue after announcement of the record date.

(3) If the issuer withdraws the rights issue after announcing the record date, it shall not make an application for listing of any of its specified securities on any recognised stock exchange for a period of ***twelve months*** from the record date announced under sub-regulation (1);

Provided that the issuer may seek listing of its equity shares allotted pursuant to conversion or exchange of convertible securities issued prior to the announcement of the record date, on the recognised stock exchange where its securities are listed.

Restriction on Rights Issue

(1) No issuer shall make a rights issue of equity shares unless it has made reservation of equity shares of the same class in favour of the holders of outstanding convertible debt instruments, in proportion to the convertible part thereof.

(2) The equity shares reserved for the holders of fully or partially convertible debt instruments shall be issued at the time of conversion of such convertible debt instruments on the same terms at which the equity shares offered in the rights issue were issued.

Letter of Offer, Abridged Letter of Offer, Pricing and Period of Subscription

(1) The abridged letter of offer, along with application form, shall be despatched through registered post or speed post to all the existing shareholders at least three days before the date of opening of the issue. Provided that the letter of offer shall be given by the issuer or lead merchant banker to any existing shareholder who has made a request in this regard.

(2) The shareholders who have not received the application form may apply in writing on a plain paper, along with the requisite application money.

(3) The shareholders making application otherwise than on the application form shall not renounce their rights and shall not utilise the application form for any purpose include renunciation even if it is received subsequently.

(4) Where any shareholder makes an application on application form as well as on plain paper, the application is liable to be rejected.

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* As amended upto 24th March, 2015. ** Record date is a date which determines the actual holder of securities for rights entitlement. It is fixed by the company in advance.

(5) the issue price shall be decided before determining the record date which shall be determined in consultation with the designated stock exchange.

(6) A rights issue shall be open for subscription for a minimum period of ***fifteen days*** and for a maximum period of ***thirty days***.

(7) The issuer shall give only one payment option out of the following to all the investors—

(a) part payment on application with balance money to be paid in calls; or

(b) full payment on application.

Provided that where the issuer has given the part payment option to investors, the part payment on application shall not be less than 25% of the issue price and such issuer shall obtain the necessary regulatory approvals to facilitate the same.

Pre-Issue Advertisement for Rights Issue

(1) The issuer shall issue an advertisement for rights issue disclosing the following :

(a) the date of completion of despatch of abridged letter of offer and the application form;

(b) the centres other than registered office of the issuer where the shareholders or the persons entitled to receive the rights entitlements may obtain duplicate copies of the application forms in case they do not receive the application form within a reasonable time after opening of the rights issue;

(c) a statement that if the shareholders entitled to receive the rights entitlements have neither received the original application forms nor they are in a position to obtain the duplicate forms, they may make application in writing on a plain paper to subscribe to the rights issue;

(d) a format to enable the shareholders entitled to apply against their rights entitlements, to make the application on a plain paper specifying therein necessary particulars such as name, address, ratio of rights issue, issue price, number of equity shares held, ledger folio numbers, depository participant ID, client ID, number of equity shares entitled and applied for, additional shares, if any, amount to be paid along with application, and particulars of cheque, etc. to be drawn in favour of the issuer's account;

(e) a statement that the applications can be directly sent by the shareholders entitled to apply against rights entitlements through registered post together with the application moneys to the issuer's designated official at the address given in the advertisement;

(f) a statement to the effect that if the shareholder makes an application on plain paper and also on application form both his applications shall be liable to be rejected at the option of the issuer.

(2) The advertisement shall be made in at least one English national daily newspaper with wide circulation, one Hindi national daily newspaper with wide circulation and one regional language daily newspaper with wide circulation at the place where registered office of the issuer is situated, at least three days before the date of opening of the issue.

Reservation for Employees alongiwith Rights Issue

Subject to other applicable provision of these regulations the issuer may make reservation for employees alongwith rights issue subject to the condition that value of allotment to any employees shall not exceed ***two lakhs rupees***.

Utilisation of Funds Raised in Rights Issue

The issuer shall utilise funds collected in rights issues after the finalisation of the basis of allotment.

List of Companies Issued Rights Shares in 2015 [upto May 2015]

Name of the Company	Rights Ratio	Face Value	Premium	Date of Announcement	Date of Record
Mack Trading Limited	2 : 5	10	0	11.08.2014	22.05.2015
Tata Motors Limited	6 : 109	2	448	27.01.2015	08.04.2015
Zee Media Limited	3 : 10	1	17	20.10.2015	17.03.2015
GMR Infra Limited	3 : 14	1	14	16.09.2014	12.03.2015
State Bk Travan Limited	1 : 5	10	390	26.03.2015	04.03.2015
Can Fin Homes Limited	3 : 10	10	440	24.07.2014	27.01.2015

Comparison Between Rights Issue and Public Issue

	Rights Issue		Public Issue
1.	A rights issue is made to existing shareholders who are familiar with the operations of the company.	1.	A public issue is made to the public at large.
2.	The flotation cost is low.	2.	The flotation cost is high.
3.	The price of a rights issue is made much less than the existing market price.	3.	The price of a public issue is generally lower than the expected market price.

Distinction Between Bonus Shares Issue and Rights Shares Issue

	Bonus Shares Issue		Rights Shares Issue
1.	It is issued free of cost..	1.	It is issued at a cost which is less than market price of the share.
2.	After issue of bonus shares, there is no change in the 'Shareholders' Fund'. Reserve and surplus is converted into equity share capital.	2.	After issue of rights shares, there will be a change in the 'Shareholders' Funds'.
3.	There is no cash inflow.	3.	The cash inflow will be there.
4.	It is issued to make the shareholders happy.	4.	It is issued to meet urgent requirement of funds.
5.	The debt-equity ratio will remain same after the issue of bonus shares.	5.	The debt-equity ratio will change after the issue of rights shares.
6.	The Earning Per Share (EPS) will fall.	6.	The Earning Per Share may not fall, if the fund is used for earning more revenue.
7.	It is issued at par.	7.	It is generally issued at a premium. (See the list of rights issue in the previous page.)
8.	There is no change in the 'Assets' section of the Balance Sheet after the issue of bonus shares.	8.	Both 'Equity and Liability' and 'Assets' section of the Balance Sheet will change after the issue of rights shares.
9.	It is issued as fully paid-up.	9.	It may be issued as partly paid-up.
10.	There is no question of 'Minimum subscription' in case of bonus issue.	10.	The 'Minimum Subscription' is applicable to rights issues. In the event of a company not getting minimum of 90% subscription, it will have to return the entire money received.
11.	There is no scope for renounce of the bonus shares.	11.	Rights shares may be renounced in favour of others.
12.	Bonus Shares are issued when the company has large accumulated resources.	12.	Rights shares are issued when the company needs funds for expansion or diversification, etc.

Letter of Offer and Composite Application Form

In case of rights issue, each shareholder receives a letter of offer along with a composite application form.

The letter of offer provides all information regarding the issue.

The composite application form has ***four*** parts :

Part A : Form of Acceptance and Application of Equity Shares

Here, the number of equity shares alongwith the additional shares applied is to be mentioned by the shareholder.

Part B : Form of Renunciation

Here, the shareholder has to mention the name of the person and the number of shares he has renounced.

Part C : Form of Application by Renouncee(s)
Here, the number of equity shares applied from the shares renounced plus any additional shares applied, if any, is to be mentioned by the renouncee.

Part D : Request for Split Application Form Request for split form is entertained by the company, only once, if the shareholder accepts the offer in part and renounce the other part in favour of another person, i.e., renouncee.

Some Important Items

Period of Subscription

Rights issues shall be kept open for at least 15 days and not more than 30 days.

Renunciation

An equity shareholder has the right to renounce his entitlement of the equity shares in full or in part in favour of any other person(s), ***subject to the approval of the Board***. Renounce means to give up rights voluntarily or formally. A letter of allotment for shares may be renounced in favour of a person other than the one to whom the letter was addressed. This is done when the shares embodied in the letter are sold to that other person. A person in whose favour the equity shares are renounced has no further right to renounce.

Additional Shares

An equity shareholder is eligible to apply for additional shares over and above the number of shares offered to him provided he has applied for all the shares offered to him without renouncing them in whole or in part in favour of any other person(s).

The application for additional shares is generally considered and allotment is made at the absolute discretion of the Board of Directors of the company and in consultation, if necessary, with the designated Stock Exchange. The Board has the power to reject any such application for additional shares without assigning any reasons.

Basis of Allotment

In the event of excess application, the basis of allotment is finalised in consultation with the designated Stock Exchange (e.g., BSE) and allotment is made only with the overall size of the rights issue. The company cannot retain any oversubscription.

The allotment is made in the following order of priority :

(a) Full allotment is made to the equity shareholders who have applied for their rights entitlements either in full or part.
(b) Full allotment to renouncee(s) who have applied for shares renounced in their favour either in full or part.
(c) Allotment to the equity shareholders who having applied for their full rights entitlements of shares offered to them have applied for additional shares provided there is a surplus available after full allotment under (a) and (b) above. This is generally done as far as possible on an equitable basis.
(d) Allotment to renouncees who have applied for additional shares, provided there is a surplus available after (a), (b) and (c) above.
(e) After taking into account (a) to (d), if there is still any surplus, the ***unsubscribed portion*** shall be disposed off at the absolute discretion of the Board of Directors.

CASE STUDY

Manappuram General Finance and Leasing Limited

Basis of Allotment

Offer of 15,00,000 Equity Shares of ₹. 10 each for cash at par aggregating ₹ 1,50,00,000 on Rights basis in the ratio of 1 : 2

The Board of Directors of the company thank the investors for the response to the Company's Rights Issue which opened on 01.08.2003 and closed on 01.09.2003.

The Company has received 880 applications for 1735765 shares.

Since all the applications are valid, the Basis of Allotment was finalized in consultation with Cochin Stock Exchange Limited on 13.09.2003 the details of which are as follows :

Basis of Allotment in respect of Equity Shares

Applicants Category	No. of Applications	Entitled Rights Shares Accepted	Additional Shares Applied	Total Shares Applied	Total Shares Allotted
Shareholders	102	6,50,375	4,83,350	11,33,725	11,33,725
Renouncees	778	18,754	5,83,286	6,02,040	3,66,275
Total	880	6,69,129	10,66,636	17,35,765	15,00,000

The Allotment of Equity Shares has been made by the Company on 13.09.2003. The Refund Orders, Allotment Advice and shares certificates were despatched on 16.09.2003.

All correspondence in respect of the above Rights Issue may be addressed to our Registrars to the Issue at the below mentioned address :

M/s. Cameo Corporate Service Limited
Unit : Manappuram General Finance and Leasing Ltd., – Rights Issue
V Floor, Subramaniam Building, No. 1 Club House Road, Chennai 600 002
Ph. No. 2860390 (5 Lines), Fax : 28460129

For Manappuram General Finance and Leasing Limited

Place : Chennai C. Radhakrishnan
Date : 16.09.2003 (Company Secretary)

Explanation : The above basis of allotment can be explained as under :

		Nos.
Total shares applied		17,35,765
Less: Allotted to equity shareholders who have exercised their rights in full or part	(A)	6,50,375
		10,85,390
Less: Allotted to renouncees who have applied for shares renounced in their favour in full or part	(B)	18,754
		10,66,636
Less: Allotted to equity shareholders who have applied for additional shares	(C)	4,83,350
Additional Shares Applied by the Renouncees		5,83,286
Less: Allotment to renouncees on pro-rata basis (Note 1)	(D)	3,47,521
Excess Application Refunded		2,35,765

Total shares allotted = (A) + (B) + (C) + (D)
= 6,50,375 + 18,754 + 4,83,350 + 3,47,521 = **15,00,000 shares**.

Total shares allotted to renouncees = 18,754 + 3,47,521 = **3,66,275 shares**.

Working Note : (1)	Total shares applied	17,35,765
	Less: Allotted Under (A), (B) and (C)	11,52,479
	Additional Shares to be issued to renouncees	3,47,521

Illustration 9

From the following information, prepare a statement showing the basis of allotment in respect of a rights issue:

Futura Polyesters Limited issues 1,48,78,729 equity shares of ₹ 10 each for cash at par on rights basis.

Applicants	Applications Received	Entitled Shares Applied	Additional Shares Applied	Total Shares Applied
Shareholders	6,318	1,05,26,783	81,15,599	1,86,42,382
Renouncees	1,156	14,28,899	26,43,008	40,71,907
	TOTAL	1,19,55,682	1,07,58,607	2,27,14,289

Solution

Futura Polyester Limited
Statement Showing the Basis of Allotment

		Nos.
Total shares applied		2,27,14,289
Less: Allotted to equity shareholders who have exercised their rights in full or part	(A)	1,05,26,783
		1,21,87,506
Less: Allotted to renouncees who have applied for shares renounced in their favour in full or part	(B)	14,28,899
		1,07,58,607
Less: Allotted to equity shareholders who have applied for additional shares [1,48,78,729 – 1,05,26,783 – 14,28,899]	(C)	29,23,047
Excess Application Refunded		78,35,560
Share Allotted to :		
Shareholders — 1,05,26,783 + 29,23,047		1,34,49,830
Renouncees		14,28,899
		1,48,78,729

For reporting purpose the above matter should be shown as :

Statement Showing the Basis of Allotment

Applicants	No. of Valid Applications Received	Entitled Shares Applied and Allotted	Additional Shares Applied	Additional Shares Allotted	Total Shares Allotted
Shareholders	6,318	1,05,26,783	81,15,599	29,23,047	1,34,49,830
Renouncees	1,156	14,28,899	26,43,008	0	14,28,899
Total	7,474	1,19,55,682	1,07,58,607	29,23,047	1,48,78,729

Accounting Entries

1. When application money is received for rights share

Bank Account Dr.
To Equity Shares Application Account
(Being application money received for....... shares)

2. When shares are allotted

Equity Shares Application Account Dr.
To Equity Shares Capital Account
To Securities Premium Account
(Being the allotment of ... shares as per Board's Resolution No. ... dated ...)

Illustration 10

National Textiles Ltd, have an issued capital of 20,000 equity shares of ₹ 10 each fully called-up.

The following decisions are taken by the company:

(a) To forfeit 100 shares on which only ₹ 5 per share has been paid-up and to re-issue them at ₹ 15 per share as fully paid-up.

(b) To issue 'Right Shares' in the ratio of 1 fully paid-up share for every 4 existing shares held, at ₹ 15 per share. Assuming that the company has sufficient general reserve, record the above through Journal entries.

Solution

In the books of National Textile Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
(a)	Equity Share Capital A/c (100 x 10)	Dr.	1,000	
	To Calls-in-Arrear A/c			500
	To Forfeited Shares A/c			500
	(Being forfeiture of 100 shares for non-payment of call money as per Boards' Resolution No... dated...)			
	Bank A/c	Dr.	1,500	
	To Equity Share Capital A/c			1,000
	To Securities Premium A/c			500
	(Being re-issue of 100 shares of ₹ 10 each as fully paid-up at a premium of ₹ 5 per share as per Boards' Resolution No... dated...)			
	Forfeited Shares A/c	Dr.	500	
	To Capital Reserve A/c			500
	(Being the profit on re-issue transferred to Capital Reserve Account)			
(b)	Bank A/c	Dr.	75,000	
	To Equity Share Application A/c			75,000
	(Being application money received for 5,000 rights shares @ ₹ 15 each)			
	Equity Share Application A/c	Dr.	75,000	
	To Equity Share Capital A/c			50,000
	To Securities Premium A/c			25,000
	(Being issue of 1 Rights Share for 4 shares held @ ₹ 15 each, as per Board's Resolution No... dated...)			

Illustration 11

The following is the abstracts of Balance Sheet of T Ltd. as on 31.3.2017 :

Issued and Paid-up Capital	₹
20,000 Equity Shares of ₹ 10 each fully paid-up	2,00,000
Reserves and Surplus :	
Securities Premium	30,000
General Reserve	1,00,000
Profit and Loss Account	80,000

At the annual general meeting of the company, the following resolution were passed :

(i) to issue 2 bonus shares for every five shares held as on date; and

(ii) to give existing shareholders the option to purchase three ₹ 10 Rights shares at ₹ 14 per share for every five shares held before the issue of bonus shares.

All the shareholders took up the option of Rights shares and Bonus shares were duly allotted.

Show appropriate journal entries to record the above transactions in the books of T Ltd.

Solution

(i) Number of Bonus Shares to be Issued :

It is given that 2 bonus shares will be given for every 5 shares held. Therefore, total number of bonus shares will be :

$$\frac{20,000}{5} \times 2 = \textbf{8,000 shares}$$

(ii) Number of Rights Shares to be Issued :

It is given that the holders of 5 shares can subscribe 3 shares of ₹ 10 each @ ₹ 14 per share. Therefore, the number of Rights Shares:

$$\frac{20,000}{5} \times 3 = \textbf{12,000 shares}$$

In the books of Bharat Shoe Co. Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
?	Securities Premium A/c	Dr.	30,000	
	General Reserve A/c	Dr.	50,000	
	To Bonus to Shareholders A/c			80,000
	(Being the declaration of bonus in the ratio of 2 : 5 as per Board's Resolution No. ... dated ... as confirmed in Shareholders' Meeting No. ... dated ...)			

?	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Being the issue of 8,000 equity shares of ₹ 10 each as bonus as per Board's Resolution No. ... dated ...)	80,000	 80,000
2017 April 1	Bank A/c Dr. To Equity Share Application A/c (Being application money received for 12,000 rights equity shares @ ₹ 14 each)	1,68,000	 1,68,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being issue of 12,000 equity shares of ₹ 10 each at a premium of ₹ 4 per share as per Board's Resolution No. ... dated ...)	1,68,000	 1,20,000 48,000

Effects of Rights Issue

The theoretical market price after rights issue is calculated as under :

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

OR

$$\frac{(\text{Market price before rights issue} \times \text{No. of existing shares}) + (\text{Rights issue price} \times \text{No. of rights shares issued})}{\text{Total number of shares after rights issue}}$$

Example :

Net Profit	Year : 2000 — ₹ 11,00,000; Year : 2001 — ₹ 15,00,000
Number of Shares outstanding prior to rights issue	5,00,000 shares
Rights issue	One new share for each five outstanding (i.e., 1,00,000 new shares) Rights issue price : ₹ 15.00; Last date to exercise rights : 1st March, 2001
Fair value of one equity share immediately prior to exercise of rights on 1st March, 2001	₹ 21.00

$$\text{Theoretical ex-rights fair value per share} = \frac{(₹\ 21.00 \times 5{,}00{,}000 \text{ shares}) + (₹\ 15.00 \times 1{,}00{,}000 \text{ shares})}{5{,}00{,}000 \text{ shares} + 1{,}00{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00. [*Source* : A Reader on Accounting Standards — ICAI]

Illustration 12

Fitness Ltd. is planning to raise funds by making rights issue of equity shares to part finance its expansion. the existing equity share capital of the company is ₹ 40 lakhs and the market value is ₹ 45 per share. The company offered to its shareholders the right to buy 2 shares of ₹ 10 each at ₹ 12 per share for every 5 shares held.

You are required to calculate : (i) Theoretical market price per share after the rights issue; (ii) The value of the rights; and (iii) Percentage increase in share capital. *[C.S — December, 2015]*

Solution

(i) Calculation of Theoretical Market Price per Share after Rights Issue

Theoretical Market Price =

$$\frac{(\text{Market Price before Rights Issue} \times \text{No. of Eisting Shares}) + (\text{Rights Issue Price} \times \text{No. of Rights Issue})}{\text{Total No. of Shares after Rights Issue}}$$

$$= \frac{(45 \times 4{,}00{,}000) + (12 \times 1{,}60{,}000)}{5{,}60{,}000 \text{ Shares}}$$

$$= \frac{1{,}80{,}000 + 19{,}20{,}000}{5{,}60{,}000 \text{ Shares}} = ₹\ \mathbf{35.57}$$

(ii) Value of Rights = Market Price – Theoretical Price

= ₹ 45 – ₹ 35.57

= ₹ **9.43**

(iii) Percentage of Increase in Share Capital $= \frac{\text{No. of Rights Issue Issued}}{\text{Total No. of Shares before Rights}} \times 100$

$$= \frac{1,60,000}{4,00,000} \times 100 = 40\%$$

Working Notes :

(1) No. of Shares before Rights Issue $= \frac{40,00,000}{10} = 4,00,000$ Shares

(2) No. of Rights Issue $= \frac{4,00,000}{5} \times 2 = 1,60,000$ Shares

(3) Total No. of Shares after Rights Issue = 4,00,000 + 1,60,000 = 5,60,000 Shares

Stock Split

Stock split is the process of reducing the face value of the shares of a company by dividing one share into two or more parts. Thus shares of ₹ 10 each may be split into ten times the number of shares of ₹ 1 each. Therefore, stock split is the sub-division of shares — the division of shares of one face value into a larger number of shares of a smaller face value, which has the same effect on the market price. Each shareholder is given enough shares so that his or her total fraction of the company owned, remains the same. The effect of a stock split is that only the number of outstanding shares goes up — net assets do not change.

A share is generally split that has a high price (known as heavy share) relative to the average price of shares on the market. This is because, the price may be high enough to discourage small investors. Generally, retail investors tend to prefer to buy larger numbers of low-priced shares. A company might split its shares when it feels its share's price has risen beyond what an individual investor is willing to pay. Therefore, the object of a stock split is to increase the amount of trading in the shares. As more of the investing public is attracted by the lower price, a stock split increases liquidity. Since the number of shares increases, the amount that investors are willing to buy or sell also goes up.

For example, an investor may be willing to buy one share for ₹ 200, but may not be interested if the share price is ₹ 2,000.

Since a stock split results in the market price falling immediately in the ratio of the split, the liquidity of the shares improves, thus opening the way for further appreciation in the stock price.

There is a reverse or unwelcome aspect of a stock split. Many companies have found a new method of raising money at a large premium. In the recent past, some companies have split their ₹ 10 shares into lower denominations before filing their applications with SEBI for new issue of shares. This enabled them to claim a larger premium on split shares.

For example, a ₹ 2 share offered at a premium of ₹ 8 looks like at a normal share being offered at par at ₹ 10. But in reality, the ₹ 10 share is available at ₹ 50 or a premium of ₹ 40. For many investors, this does not catch the eyes. SEBI has observed that many issuers were going in for share splits just before the IPO. In effect, SEBI has amended the guidelines to restrict pre-IPO splitting of shares.

Comparison of Bonus Shares and Stock Split

Points of Similarity

(1) Both are accounting gimmic that actually adds nothing to a company's fundamentals.
(2) They increase the number of shares available for trade.
(3) Both keep shareholders happy.
(4) Shareholders equity does not change in either case.
(5) Under both cases net assets remain the same.

Points of Distinction

	Bonus Shares		Stock Split
1.	The face value of the shares does not change.	1.	The face value of the shares is reduced.
2.	Bonus shares are declared by transferring reserves.	2.	There is no such transfer in a stock split.
3.	The dividend payout of the company is likely to increase.	3.	The dividend pay-out is not affected by a stock split.
4.	Issue of bonus shares increases the total paid-up capital of the company.	4.	The total paid-up capital remains unaffected by a stock split.
5.	Bonus shares are issued when the company has large accumulated reserves.	5.	A share is generally split that has a high price.

List of Companies which went for Stock Split in the year 2014

Split Date	Company	Old Face Value (₹)	New Face Value (₹)
02-07-2014	Swadeshi Industries Ltd.	10	1
26-06-2014	Orosil Smiths Ltd.	10	5
24-06-2014	Thacker Ltd.	5	1
20-06-2014	Deepak Nitrite Ltd.	10	2
05-06-2014	Greencrest Finance Ltd.	10	1
23-05-2014	Trinity Trade Ltd.	10	1
30-04-2014	Rekvina Labs Ltd.	10	5
23-04-2014	Matra Kaushal Ltd.	10	1
23-04-2014	Cubical Financial Services Ltd.	10	2
04-04-2014	Swagruha Infra Ltd.	10	1
03-04-2014	CHL Ltd.	10	2
27-03-2014	Vikas GolbalOne Ltd.	10	1
25-03-2014	Raj Television Ltd.	10	5
19-03-2014	Vishvjyoti Trading Ltd.	10	1
19-03-2014	Premier Cap ltd.	10	1
14-03-2014	Atlanta Infra Ltd.	10	1
03-03-2014	Guj Auto Gears Ltd.	10	2
26-02-2014	R Systems Intl Ltd.	10	1
26-02-2014	Finkurve Fin Ltd.	10	1
20-02-2014	Sharon Bio Medi Ltd.	10	2
03-02-2014	Swan Energy Ltd.	2	1
29-01-2014	Sam Leaseco Ltd.	10	1
27-01-2014	Kaveri Seed Ltd.	10	2
21-01-2014	BS Limited	10	1
16-01-2014	Mishka Finance Ltd.	10	1
13-01-2014	Cressanda Solution Ltd.	10	1
10-01-2014	Thacker Ltd.	10	5
09-01-2014	Maa Jagdambe Ltd.	10	2

KEY POINTS

- Bonus shares are shares issued by a company free of cost to its existing shareholders on a pro-rata basis.
- When bonus shares are given, the 'Shareholders' Funds' does not change and, ***the assets section of the Balance Sheet remains unaffected***. On the 'Equity and Liabilities' section, the reserves are ***reduced*** by the amount of the ***increase*** in the equity share capital.
- ***A bonus issue has two implications :*** *First*, it increases the number of shares available for trade. *Second,* it signals the management's confidence in accelerating or at least maintaining the profit growth.
- A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—
  (i) its free reserves;
  (ii) the securities premium account; or
  (iii) the capital redemption reserve account.
  Provided that no issue of bonus shares shall be made by capitlising reserves ***created by the revaluation of assets***.
- Bonus Debentures are debentures issued by a company to its existing shareholders ***free of cost***. These debentures carry normal rate of interest and these are redeemed after a certain period.
- a rights issue is a cheap and faster way of raising finance. It is an issue of shares in which the existing shareholders have a pre-emptive right to subscribe for the new shares.
- Stock split is the process of reducing the face value of the shares of a company by dividing one share into two or more parts.

THEORETICAL QUESTIONS

1. (a) What is a bonus share ?
   (b) State the Provision of the Companies Act, 2013 for the issue of bonus shares.
2. Discuss the sources from which bonus shares can be issued by a company.
3. Discuss the latest guide lines issued by the the SEBI for the issue of bonus shares.
4. What is a rights share ? State the Provision of the Companies Act, 2013 for the issue of rights share.
5. What is bonus debentures ? What are the logics of issuing bonus debentures ?
6. Distinguish between 'Bonus Shares' and 'Bonus Debentures'.
7. What do you mean by stock split ?
8. Distinguish between 'Rights Share Issue' and 'Bonus Share Issue'.
9. What are the advantages and disadvantages of issuing bonus shares ?
10. Distinguish between Bonus Shares and Stock Split.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Before issue of bonus shares
   A the partly paid-up shares, if any, are to be forfeited
   B the partly paid-up shares, if any, are to be made fully paid-up
   C the partly paid-up shares, if any, will be converted into fully paid-up without receiving any cash
   D the partly paid-up shares, if any, will be shown in the Balance Sheet without any change
2. The bonus issue should be made out of free reserves and
   A it does not include securities premium
   B it includes all securities premium received in cash or kind
   C it includes securities premium received in kind only
   D it includes securities premium received in cash only
3. The company shall implement the bonus issue
   A within 45 days from the date of approval of the issue by its board of directors
   B within 30 days from the date of approval of the issue by its board of directors
   C within 15 days from the date of approval of the issue by its board of directors
   D within 7 days from the date of approval of the issue by its board of directors

4. In a rights issue
   A normal prospectus is issued
   B red-herring prospectus is issued
   C no prospectus is issued
   D red-herring prospectus is issued before final prospectus
5. Stock split is the process of
   A consolidating the face value of the shares of the company
   B reducing the capital of the company
   C restruicturing the capital of the company
   D reducing face value of shares of the company by dividing one share into two or more parts
6. A company makes a bonus issue of shares. What is the effect on the net assets and the reserves in the Balance Sheet?

	Net Assets	Reserves
A	increase	decrease
B	increase	unchanged
C	unchanged	decrease
D	unchanged	increase

7. What will result in an increase in cash funds to a business ?
   A bonus issue of shares;
   B increase in authorised share capital;
   C revaluation of fixed assets;
   D rights issue of shares.
8. Which statement about bonus share is true ?
   A they may be issued as repayment of debentures
   B they may be issued at a premium
   C they may be issued to the holders of preference shares
   D they may be issued using the premium received from an issue of preference shares.
9. A company's share capital consists of 1,50,000 equity shares of ₹ 5 each. It makes a rights issue of 1 equity shares for every 3 already held at ₹ 12 per share. It then makes a bonus issue of 1 equity share for every 5 held. Which amount will be shown in the Balance Sheet for share capital ?
   A ₹ 12,00,000;
   B ₹ 14,50,000;
   C ₹ 15,50,000;
   D ₹ 16,50,000.
10. A company's Balance Sheet as at 31.12.2014 included :

	₹
Equity Shares of ₹ 5 each, fully paid	32,00,000
Cash at Bank	10,00,000

The following then took place :
2015
February A one-for-two rights issue of equity shares of ₹ 5 each at ₹ 11. The issue was fully subscribed.
April A bonus issue of one-for-four equity shares of ₹ 5 each.
Assume no other transactions took place between 31.12.2014 and 30.4.2015. What were the balances of the equity share capital and bank accounts on 30.4.2015 ?

	Equity Share Capital (₹)	Bank (₹)
A	60,00,000	45,20,000
B	60,00,000	57,20,000
C	84,00,000	45,20,000
D	84,00,000	62,00,000

PRACTICAL QUESTIONS

1. Sweetwell Co. Ltd has a share capital of ₹ 7,00,000 in equity shares of ₹ 10 each which are quoted in the market at ₹ 20. The company now declares a bonus is to be paid by issue of 40,000 fully paid equity shares of ₹ 10 each. Show the necessary Journal Entries to record these transactions.
2. The following are the extracts from the Balance Sheet of A Ltd as on 31.3.2017:
   Authorised capital : 10,000 Equity Shares of ₹ 10 each : ₹ 1,00,000
   Issued and Subscribed Capital : 5,000 Equity Shares of ₹ 10 each fully paid-up : ₹ 50,000
   Reserves and Surplus : General Reserve : ₹ 35,000; Profit and Loss Account : ₹ 10,000.
   A resolution was passed to issue 1,000 shares of ₹ 10 each by providing ₹ 5,000 out of the Profit and Loss Account and the Balance Sheet of the general reserve.
   Set out Journal Entries to give effect to the resolution and show how they affect the Balance Sheet.
3. The following are the extract from the Draft Balance Sheet of Omega Tools Ltd as on 31st March, 2017.

	₹
Authorised capital : 1,00,000 Equity Shares of ₹ 10 each	10,00,000
Issued, Called-up and Paid-up Capital : 80,000 Equity Shares of ₹ 10 each	8,00,000
Securities Premium	1,00,000
General Reserve	3,50,000
Profit and Loss Account	2,50,000

   A resolution was passed declaring one bonus share for four shares held. Set out Journal Entries to give effect to the resolution stated above.
4. The authorised capital of a company is ₹ 12,00,000 divided into 12,000 Equity Shares of ₹ 100 each. Out of which 8,000 shares have been subscribed. The company has the following undisposed off balances :
   (a) ₹ 2,30,000 (Cr.) in the Profit and Loss Account; and
   (b) ₹ 2,85,000 in the General Reserve.
   The company has decided in general meeting to capitalise the necessary parts of the above balance by issuing 1,000 fully paid Equity Shares at par as bonus at the rate of one fully paid share for eight shares held. The balance of the Profit and Loss Account is first to be exhausted and then the General Reserve is to be drawn upon.
   Give Journal Entries to give effect to the above transaction.
5. The following was the Balance Sheet of Zodiac Ltd. as at 30.9.2016 :

Balance Sheet of Zodiac Ltd. as at 30th September, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus — General Reserve	(2)	2,10,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(4) Current Liabilities :		
(a) Trade Payables		40,000
TOTAL		4,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	4,00,000
(2) Current Assets :		
(d) Cash and Cash Equivalents		50,000
TOTAL		4,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
30,000 Equity Shares of ₹ 10 each	3,00,000
Issued Capital :	
25,000 Equity Shares of ₹ 10 each	2,50,000
Subscribed Capital :	
Subscribed but not Fully Paid :	
25,000 Equity Shares of ₹ 10 each (₹ 8 paid)	2,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	10,000
Capital Redemption Reserve	50,000
Profit and Loss Account	50,000
General Reserve	1,00,000
	2,10,000

(3) Fixed Assets

(a) *Tangible Assets*	
Land	2,00,000
Plant and Machinery	2,00,000
	4,00,000

The directors recommended the following with a view to capitalising Reserve :
(i) existing shares be made fully paid without taking money from shareholders; and
(ii) each shareholder to receive one bonus share for every two shares held by him.
For this purpose, General Reserve will be used last of all. The scheme was accepted.
Show the Journal Entries to recor the above transactions and Balance Sheet after issue of bonus shares.

6. From the following prepare a statement showing the basis of allotment in respect of a rights issue :
1. Centurion Bank Limited issues 22,69,44,320 equity shares on rights basis.
2.

Applicants	Applications Received	Entitled Shares Applied	Additional Shares Applied
Shareholders	64,470	17,70,65,995	7,94,22,618
Renouncees	3,568	3,65,16,884	79,95,141

Guide to Answer

Multiple Choice

1. B; 2. D; 3. C; 4. C; 5. D; 6. C; 7. D; 8. D; 9. A; 10. A.

Practical Questions

6.

Statement Showing the Basis of Allotment

Applicants	No. of valid applications received	Entitled Shares applied and allotted	Additional Shares applied	Additional Shares allotted	Total Shares allotted
Shareholders	64,470	17,70,65,995	7,94,22,618	1,33,61,441	19,04,27,436
Renouncees	3,568	3,65,16,884	79,95,141	–	3,65,16,884
Total	68,038	21,35,82,879	8,74,17,759	1,33,61,441	22,69,44,320

3

Employee Stock Option Scheme/Plan

Employees Stock Option Scheme (ESOS)

According to Section 2(37) of the Companies Act, 2013, "***employees' stock option***" means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

Nowadays, under this scheme many companies (particularly software companies and construction engineering companies) are offering equity shares to their employees at a concessional price. The main aim of this scheme is to retain good employees in the organisation and involve them in the affairs of the company.

Under an ESOS (Employee Stock Option Scheme) the employee's gain is the difference between market price of the shares and exercise price. ***For example,*** the market price of share of X Ltd. is ₹ 1,000 but under ESOS an employee can get it at ₹ 600 (the exercise price). The gain per option is ₹ 400 (₹ 1,000 – ₹ 600).

It should be pointed out that the enterprise will lose ₹ 400 for each option. Let us assume that the number of employees are 1,000. Therefore, the total loss will be ₹ 400 × 1,000 = ₹ 4,00,000.

If the vesting period is one year, the entire ₹ 4,00,000 will be recognised as expenses in that year. If the vesting period is 2 years, the amount to be recognised in each year is ₹ 2,00,000 (₹ 4,00,000 ÷ 2) assuming that no employee left the enterprise during these two years.

It should be noted that the regulation related to ESOS for ***listed companies*** and ***other than listed companies*** are separate.

Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 is applicable to a company, ***other than a listed company***.

The SEBI Regulations (Share Based Employee Benefits), 2014 is applicable to ***listed companies*** in India.

The Companies (Share Capital and Debentures) Rules, 2014

Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 states that :

A company, ***other than a listed company***, which is not required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines shall not offer shares to its employees under a scheme of employees' stock option (hereinafter referred to as ''Employees Stock Option Scheme''), unless it complies with the following requirements, namely:-

(1) the issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a ***special resolution***.

For the purpose of this rule ''Employee'' means:

(a) a permanent employee of the company who has been working in India or outside India; or

(b) a director of the company, whether a whole time director or not but excluding an independent director; or

(c) an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the company or of an associate company but does not include-

(i) an employee who is a promoter or a person belonging to the promoter group; or

(ii) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.

(2) The company shall make the following disclosures in the explanatory statement annexed to the notice for passing of the resolution-

(a) the total number of stock options to be granted;

(b) identification of classes of employees entitled to participate in the Employees Stock Option Scheme;

(c) the appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme;

(d) the requirements of vesting and period of vesting;

(e) the maximum period within which the options shall be vested;

(f) the exercise price or the formula for arriving at the same;

(g) the exercise period and process of exercise;

(h) the Lock-in period, if any ;

(i) the maximum number of options to be granted per employee and in aggregate;

(j) the method which the company shall use to value its options;

(k) the conditions under which option vested in employees may lapse e.g. in case of termination of employment for misconduct;

(l) the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee; and

(m) a statement to the effect that the company shall comply with the applicable accounting standards.

(3) The companies granting option to its employees pursuant to Employees Stock Option Scheme will have the freedom to determine the ***exercise price*** in conformity with the applicable accounting policies, if any

(4) The approval of shareholders by way of separate resolution shall be obtained by the company in case of —

(a) grant of option to employees of subsidiary or holding company; or

(b) grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

(5) (a) The company may by special resolution, vary the terms of Employees Stock Option Scheme not yet exercised by the employees provided such variation is not prejudicial to the interests of the option holders.

(b) The notice for passing special resolution for variation of terms of Employees Stock Option Scheme shall disclose full of the variation, the rationale therefor, and the details of the employees who are beneficiaries of such variation.

(6) (a) There shall be a minimum period of one year between the grant of options and vesting of option: Provided that in a case where options are granted by a company under its Employees Stock Option Scheme in lieu of options held by the same person under an Employees Stock Option Scheme in another company, which has merged or amalgamated with the first mentioned company, the period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required under this clause;

(b) The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.

(c) The Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

(7) The amount, if any, payable by the employees, at the time of grant of option-

(a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or

(b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

(8) (a) The option granted to employees shall not be transferable to any other person.

(b) The option granted to the employees shall not be pledged, hypothecated, mortgaged or otherwise encumbered or alienated in any other manner.

(c) Subject to clause (d), no person other than the employees to whom the option is granted shall be entitled to exercise the option.

(d) In the event of the death of employee while in employment, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.

(e) In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.

(f) In the event of resignation or termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the options granted to him which are vested within the period specified in this behalf, subject to the terms and conditions under the scheme granting such options as approved by the Board.

(9) The Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

(a) options granted;
(b) options vested;
(c) options exercised;
(d) the total number of shares arising as a result of exercise of option;
(e) options lapsed;
(f) the exercise price;
(g) variation of terms of options;
(h) money realized by exercise of options;
(i) total number of options in force;
(j) employee wise details of options granted to;-
  (i) key managerial personnel;
  (ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.
  (iii) identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

SEBI (Share Based Employee Benefits) Regulations, 2014

The provisions of these regulations shall apply to any company whose shares are listed on a recognised stock exchange in India.

Some of the important definitions are given below :

(a) '***employee***' means, —
   (i) a ***permanent*** employee of the company who has been working in India or outside India; or
   (ii) a director of the company, whether whole time or not but excluding an independent director; or
   (iii) an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the company or of an associate company but does not include—
      (a) an employee who is a promoter or a person belonging to the promoter group; or
      (b) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company;

(b) '***employee stock option scheme or ESOS***' means a scheme under which a company grants employee stock option directly or through a trust;

(c) '***employee stock purchase scheme or ESPS***' means a scheme under which a company offers shares to employees, as part of public issue or otherwise, or through a trust where the trust may undertake secondary acquisition for the purposes of the scheme;

(d) '***exercise***' means making of an application by an employee to the company or to the trust for issue of shares or appreciation in form of cash, as the case may be, against vested options or vested SAR* in pursuance of the schemes;

(e) '***exercise period***' means the time period after vesting within which an employee should exercise his right to apply for shares against the vested option or appreciation against vested SAR in pursuance of the schemes;

(f) '***exercise price***' means the price, if any, payable by the employee for exercising the option or SAR granted to him in pursuance of the schemes;

(g) '***grant***' means the process by which the company issues options, SARs*, shares, or any other benefits under any of the schemes;

(h) '***grant date***' means the date on which the compensation committee approves the grant;

(i) '***option***' means the option given to an employee which gives him a right to purchase or subscribe at a future date, the shares offered by the company, directly or indirectly, at a pre-determined price;

(j) '***vesting***' means the process by which the employee becomes entitled to receive the benefit of a grant made to him under any of the schemes;

(k) '***vesting period***' means the period during which the vesting of option, SAR or a benefit granted under any of the schemes takes place;

Some of the important regulations are given below :

Eligibility

An employee shall be eligible to participate in the schemes of the company as determined by the compensation committee.

Explanation.- Where such employee is a director nominated by an institution as its representative on the board of directors of the company –

(i) The contract or agreement entered into between the institution nominating its employee as the director of a company, and the director so appointed shall, inter alia, specify the following:
   a. whether the grants by the company under its scheme(s) can be accepted by the said employee in his capacity as director of the company;
   b. that grant if made to the director, shall not be renounced in favour of the nominating institution; and
   c. the conditions subject to which fees, commissions, other incentives, etc. can be accepted by the director from the company.

*The Stock Apprecation 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.

(ii) the institution nominating its employee as a director of a company shall file a copy of the contract or agreement with the said company, which shall, in turn file the copy with all the stock exchanges on which its shares are listed.

(iii) the director so appointed shall furnish a copy of the contract or agreement at the first board meeting of the company attended by him after his nomination.

Shareholders approval

(1) No scheme shall be offered to employees of a company unless the shareholders of the company approve it by passing a special resolution in the general meeting.

(2) The explanatory statement to the notice and the resolution proposed to be passed by shareholders for the schemes shall include the information as specified by SEBI in this regard.

(3) Approval of shareholders by way of separate resolution in the general meeting shall be obtained by the company in case of:

(a) Secondary acquisition for implementation of the schemes. Such approval shall mention the percentage of secondary acquisition (subject to limits specified under these regulations) that could be undertaken;

(b) Secondary acquisition by the trust in case the share capital expands due to capital expansion undertaken by the company including preferential allotment of shares or qualified institutions placement, to maintain the five per cent. cap as prescribed under sub-regulation (11) of regulation 3 of such increased capital of the company;

(c) Grant of option, SAR, shares or other benefits, as the case may be, to employees of subsidiary or holding or associate company;

(d) Grant of option, SAR, shares or benefits, as the case may be, to identified employees, during any one year, equal to or exceeding one per cent. of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option, SAR, shares or incentive, as the case may be.

Variation of terms of the schemes

(1) The company shall not vary the terms of the schemes in any manner, which may be detrimental to the interests of the employees:
Provided that the company shall be entitled to vary the terms of the schemes to meet any regulatory requirements.

(2) Subject to the proviso to sub-regulation (1), the company may by special resolution in a general meeting vary the terms of the schemes offered pursuant to an earlier resolution of the general body but not yet exercised by the employee provided such variation is not prejudicial to the interests of the employees.

(3) The provisions of regulation 6 shall apply to such variation of terms as they apply to the original grant of option, SAR, shares or other benefits, as the case may be.

(4) The notice for passing special resolution for variation of terms of the schemes shall disclose full details of the variation, the rationale therefor, and the details of the employees who are beneficiaries of such variation.

(5) A company may reprice the options, SAR or shares, as the case may be which are not exercised, whether or not they have been vested if the schemes were rendered unattractive due to fall in the price of the shares in the stock market:
Provided that the company ensures that such repricing shall not be detrimental to the interest of the employees and approval of the shareholders in general meeting has been obtained for such repricing.

Winding up of the schemes

In case of winding up of the schemes being implemented by a company through trust, the excess monies or shares remaining with the trust after meeting all the obligations, if any, shall be utilised for repayment of loan or by way of distribution to employees as recommended by the compensation committee.

Non-transferability

(1) Option, SAR or any other benefit granted to an employee under the regulations shall not be transferable to any person.

(2) No person other than the employee to whom the option, SAR or other benefit is granted shall be entitled to the benefit arising out of such option, SAR, benefit etc. :
Provided that in case of ESOS or SAR, under cashless exercise, the company may itself fund or permit the empanelled stock brokers to fund the payment of exercise price which shall be adjusted against the sale proceeds of some or all the shares, subject to the provisions of the applicable law or regulations.

(3) The option, SAR, or any other benefit granted to the employee shall not be pledged, hypothecated, mortgaged or otherwise alienated in any other manner.

(4) In the event of death of the employee while in employment, all the options, SAR or any other benefit granted to him under a scheme till such date shall vest in the legal heirs or nominees of the deceased employee.

(5) In case the employee suffers a permanent incapacity while in employment, all the options, SAR or any other benefit granted to him under a scheme as on the date of permanent incapacitation, shall vest in him on that day.

(6) In the event of resignation or termination of the employee, all the options, SAR, or any other benefit which are granted and yet not vested as on that day shall expire:
Provided that an employee shall, subject to the terms and conditions formulated by the compensation committee under the sub-regulation (3) of regulation 5, be entitled to retain all the vested options, SAR, or any other benefit covered by these regulations.

(7) In the event that an employee who has been granted benefits under a scheme is transferred or deputed to an associate company prior to vesting or exercise, the vesting and exercise as per the terms of grant shall continue in case of such transferred or deputed employee even after the transfer or deputation.

Disclosures

In addition to the information that a company is required to disclose, in relation to employee benefits under the Companies Act, 2013, the board of directors of such a company shall also disclose the details of the scheme(s) being implemented, as specified by SEBI in this regard.

Accounting Policies

(1) Any company implementing any of the share based schemes shall follow the requirements of the 'Guidance Note on Accounting for employee share-based Payments' (Guidance Note) or Accounting Standards as may be prescribed by the Institute of Chartered Accountants of India (ICAI) from time to time, including the disclosure requirements prescribed therein.

(2) Where the existing Guidance Note or Accounting Standard do not prescribe accounting treatment or disclosure requirements for any of the schemes covered under these regulations then the company shall comply with the relevant Accounting Standard as may be prescribed by the ICAI from time to time.

Pricing

The company granting option to its employees pursuant to ESOS will have the freedom to determine the exercise price subject to conforming to the accounting policies specified in regulation 15.

Vesting Period

(1) There shall be a minimum vesting period of one year in case of ESOS:
Provided that in case where options are granted by a company under an ESOS in lieu of options held by a person under an ESOS in another company which has merged or amalgamated with that company, the period during which the options granted by the transferor company were held by him shall be adjusted against the minimum vesting period required under this sub-regulation.

(2) The company may specify the lock-in period for the shares issued pursuant to exercise of option.

Rights of the Option Holder

The employee shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to him, till shares are issued upon exercise of option.

Consequence of Failure to Exercise Option

The amount payable by the employee, if any, at the time of grant of option, -

(a) may be forfeited by the company if the option is not exercised by the employee within the exercise period; or

(b) may be refunded to the employee if the options are not vested due to non-fulfilment of conditions relating to vesting of option as per the ESOS.

Accounting Treatment of Employee Stock Option

Till now, no accounting standard has been issued in this respect. In this chapter, all the accounting treatments are based upon '***Guidance Note on Account for Employee Share-based payments***' issued by the Institute of Chartered Accountants of India. The students should read the guidance note in full for better understanding of the topic. The scope for discussion in details are limited. Therefore, only fundamental matters / concepts have been discussed here.

An enterprise should recognise the value of option as expense over vesting period. The value of option is based upon intrinsic value / fair value per share on the grant date.

The ***intrinsic value*** means the excess of the market price of the share under ESOS over the exercise price. ***For example***, the market price of each share of A Ltd. is ₹ 250 and exercise price is ₹ 100. The intrinsic value of option is ₹ 150 per share. The total value of option will depend upon the number of options granted by the enterprise. Let us assume that the number of employees of A Ltd. is 500 and all are eligible for 'Employee Stock Option'. Therefore, the total value of options = ₹ 150 × 500 = ₹ 75,000. The recognition of the total value of options depending upon the vesting period and other facts like resignation by employees, termination of service of the employees, etc., during the vesting period.

The ***fair value*** is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Illustration 1

(i) Date of grant of option	1st April, 2013
(ii) Vesting period	3 years
(iii) Number of options granted	1,250 shares
(iv) Market price of the share	₹ 200 per share
(v) Exercise price	₹ 80 per share
(v) Nominal value	₹ 10
(v) Exercise period	1 year

Assume that there was no change in the number of employees during the vesting period.

You are required to calculate the amount to be recognised as expense in each year.

Solution

(i) Intrinsic value of each option :	₹
Market price	200
Less: Exercise price	80
	120

(ii) Total value of options = ₹ 120 × 1,250 = ₹ **1,50,000**.

(iii) Each year (2013-14; 2014-15; 2015-16) amount to be recognised as an expense = ₹ 1,50,000 ÷ 3 = ₹ **50,000**.

Alternatively,

The value of options to be recognised as an expense in an accounting period can be calculated as follows :

F.Y. 2013-14

(i) Total value of option = ₹ **1,50,000**

(ii) Vested period = **3 years**.
(iii) Unamortised amount = ₹ **1,50,000**.
(iv) Number of years expired = **1 year**
(v) Amount recognised as expense = $\frac{1,50,000}{3} \times 1$ = ₹ **50,000**.

F.Y. 2014-15
(i) Vesting period = **3 years**.
(ii) Number of years expired = **2 years**
(iii) Number of year remaining = **1 year**
(iv) Cumulative expenses after the expiry of 2 years = $\frac{1,50,000}{3} \times 2$ = ₹ **1,00,000**.
(v) Expenses to be recognised in 2014-15 = ₹ 1,00,000 – ₹ 50,000 = ₹ **50,000**.

F.Y. 2015-16
(i) Vesting period = **3 years**.
(ii) Number of years expired = **3 years**
(iii) Cumulative expenses after the expiry of 3 years = $\frac{1,50,000}{3} \times 3$ = ₹ **1,50,000**.
(v) Expenses to be recognised in 2015-16 = ₹ 1,50,000 – ₹ 1,00,000 = ₹ **50,000**.

Tutorial Note : The alternative method of calculation is suitable when there is a chance of leaving of employees during the vesting period. Remember that the value of options recognised as expense in an accounting period is the excess of cumulative expense as per latest estimates upto current accounting period over total expense recognised upto the previous accounting period.

Illustration 2

HCL grants 45,000 options to employees free of cost. Each grant is based on the condition that the employees working for HCL over 3 years. The company estimated that the fair value of each share option is ₹ 15 on the date of grant. HCL estimates that 1/3rd of the employees will leave the organisation during the three year period and so forfeit their rights to the share options. Everything happened as expected.

You are required to calculate the amounts to be recognised as an expense during the three years of vesting period.

Solution

(i) Vesting period = **3 years.**
(ii) Fair value of each option = ₹ **15**.
(iii) Total value of options = ₹ 15 × 45,000 = ₹ **6,75,000**
(iv) Number of employees will leave the organisation during 3 years = 1/3rd.

Calculation of the amounts to be Recognised as Expenses

Year	Particulars	Expense for the year	Cumulative Expense
1st	₹ 6,75,000 × $\frac{2}{3} \times \frac{1}{3}$ = ₹ 1,50,000	1,50,000	1,50,000
2nd	₹ 6,75,000 × $\frac{2}{3} \times \frac{2}{3}$ = ₹ 1,50,000	1,50,000	3,00,000
3rd	₹ 6,75,000 × $\frac{2}{3} \times \frac{3}{3}$ = ₹ 1,50,000	1,50,000	4,50,000

Alternatively,
1st year :
(i) Vesting period = **3 years.**
(ii) Number of year expired = 1 year.
(ii) Number of employees will leave the organisation during 3 years = 1/3rd.

Amount to be recognised as an expense = ₹ 6,75,000 × $\frac{2}{3} \times \frac{1}{3}$ = ₹ **1,50,000**

2nd year :

(i) Vesting period = **3 years.**
(ii) Number of year expired = 2 years.
(ii) Number of employees will leave the organisation during 3 years = 1/3rd.
(iv) Remaining year = 1 year.
(v) Cumulative expense after the expiry of 2 years = ₹ 6,75,000 × $\frac{2}{3}$ × $\frac{2}{3}$ = ₹ **3,00,000**

Amount to be recognised as an expense = ₹ 3,00,000 – ₹ 1,50,000 = ₹ **1,50,000**.

(i) Vesting period = **3 years.**
(ii) Number of year expired = 3 years.
(ii) Number of employees will leave the organisation during 3 years = 1/3rd.
(iv) Cumulative expense after the expiry of 3 years = ₹ 6,75,000 × $\frac{2}{3}$ × $\frac{3}{3}$ = ₹ **4,50,000**

Amount to be recognised as an expense = ₹ 4,50,000 – ₹ 3,00,000 = ₹ **1,50,000**.

Accounting Entries

1. When the vesting period is not exceeding one year and exercise period ending on or before the closing of the accounting period

(a) Bank Account	Dr.	[Exercise Price × Number of options exercised]
Employee Compensation Expense Account	Dr.	[Value of option]
To Equity Share Capital Account		[Number of options exercised × Face value of shares]
To Securities Premium Account		[Number of options exercised × Premium per share]
(Being the issue of ... equity shares to employees under ESOS)		
(b)) Statement of Profit and Loss	Dr.	
To Employee Compensation Expense Account		[Value of option]
(Being the amount transferred to Statement of Profit and Loss)		

Illustration 3

Arihant Limited has its share capital divided into equity shares of ₹ 10 each. On 1.10.2012, it granted 20,000 employees' stock option at ₹ 50 per share, when the market price was ₹ 120 per share. The options were to be exercised between 10th December, 2012 and 31st March, 2013. The employees exercised their options for 16,000 shares only and the remaining options lapsed. The company closes its books on 31st March every year. Show Journal Entries (with narration) as would appear in the books of the company utpo 31st March, 2013. ***[C.A. (Inter) — May, 2014]***

Solution

(i) Value of option (120 – 50) × 16,000 = ₹ **11,20,000**.

In this case, vesting period is less than one year. Therefore, the entitre amount will be recognised as expense in the same year. The journal entries will be as follows :

In the books of Arihant Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
10.12.2012	Bank A/c (16,000 x ₹ 50)	Dr.		8,00,000	
to	Employee Compensation Expense A/c	Dr.		11,20,000	
31.3.2013	To Equity Share Capital A/c (16,000 x ₹ 10)				1,60,000
	To Securities Premium A/c (16,000 x ₹ 110)				17,60,000
	(Being the issue of 16,000 equity shares to employees under ESOS)				
31.3.2013	Statement of Profit and Loss	Dr.		11,70,000	
	To Employee Compensation Expense A/c				11,70,000
	(Being the amount transferred to Statement of Profit and Loss				

Alternative Solution

In the books of Arihant Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2012	Employee Compensation Expenses A/c	Dr.		14,00,000	
Oct. 1	To Employee Stock Option Outstanding A/c				14,00,000
	(Being the grant of 20,000 stock options to employee at ₹ 50. The market price of the share was ₹ 120)				
Dec. 10	Bank A/c (16,000 x 50)	Dr.		8,00,000	
	Employee Options Outstanding A/c	Dr.		11,20,000	
	To Equity Share Capital A/c				1,60,000
	To Securities Premium A/c				17,60,000
	(Being allotment of 16,000 shares of ₹ 10 each at a premium of ₹ 110 per share as per Board's Resolution No. ... dated ...)				
2013	Employee Stock Options Outstanding A/c	Dr.		2,80,000	
Mar. 31	To Employee Compensation Expenses A/c				2,80,000
	(Being the adjustment for lapsed options)				
	Statement of Profit and Loss	Dr.		11,20,000	
	To Employee Compensation Expenses A/c				11,20,000
	(Being the amount ransferred to Statement of Profit and Loss)				

Illustration 4

A company has its share capital divided into shares of ₹ 10 each. On 1st April, 2014, it granted 5,000 shares as employee stock options at ₹ 40 per share, when the market price was ₹ 130 per share. The options were to be exercised between 16th December, 2014 and 15th March, 2015. The employee exercised their options for 4,500 shares only. The remaining options lapsed. The company closes its books on 31st March every year. Show the Journal entries in the books of the company.

[CS — December, 2015]

Solution

(1) The value of options (₹ 130 – ₹ 40) × 5,000 = ₹ 4,50,000.
In this case vesting period is less than one year. Therefore, the entire amount will be recognised as expenses.

In the books of ...
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2014	Employee Compensation Expenses A/c	Dr.		4,50,000	
April 1	To Employee Stock Options Outstanding A/c				4,50,000
	(Being the grant of 5,000 stock option to employees at a price of ₹ 40 each. At the time of granting options, the price of the shares was ₹ 130 each)				
Dec. 11	Bank A/c (4,500 x ₹ 40)	Dr.		1,80,000	
	Employee Stock Option Outstanding A/c (4,500 x ₹ 90)	Dr.		4,05,000	
	To Equity Share Capital A/c				45,000
	To Securities Premium A/c				5,40,000
	(Being the allotment of 4,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share as per Board's Resolution No. ... dated ...)				
2015	Employee Stock Option Outstanding A/c (500 x ₹ 90)	Dr.		45,000	
Mar. 16	To Employee Compensation Expenses A/c				45,000
	(Being the adjustment for lapsed options of 500 shares)				
Mar. 31	Statement of Profit and Loss	Dr.		4,05,000	
	To Employee Compensation Expenses a/c				4,05,000
	(Being the amount transferred to Statement of Profit and Loss)				

2. When the vesyting period is ***exceeding one year***

(a) For recognition of compensation expense

(i) Employee Compensation Expense Account Dr. [Amount recognised as expense]
  To Employee Stock Option Outstanding Account
 (Being the compensation expense recognised)

(ii) Statement of Profit and Loss Dr.
  To Employee Compensation Expense Account
 (Being the amount transferred to Statement of Profit and Loss.)

Note : 'Employee Stock Option Outstanding' will be shown in the Balance Sheet under 'Reserve and Surplus'.

(b) For issuing shares under ESOS

Bank Account	Dr.	[Exercise price × Number of options exercised]
Employee Stock Option Outstanding Account	Dr.	[Accumulated amount]
To Equity Share Capital Account		[Number of options exercised × Face value]
To Securities Premium Account		[Number of options exercised × Securities Premium per share]

Illustration 5

Gobinda Ltd. granted 1,000 stock options to its employees on 1st April, 2013 at ₹ 50 per share. The vesting period is $2^1/_2$ years and the maximum exercise period is one year. The market price on that date is ₹ 150 per share. All the options were exercised on 30th June, 2016.

You are required to pass journal entries with suitable narrations. The face value of the equity share is ₹ 10.

Solution

The value of option = Number of Options × (Market Price – Exercise Price)
= 1,000 × (₹ 150 – ₹ 50)
= **₹ 1,00,000**

Therefore, the total employees compensation expenses = ₹ 1,00,000. This employee compensation expense has been written-off during $2^1/_2$ years on straight line basis as under :

1st year = ₹ 40,000 (Full year)
2nd year = ₹ 40,000 (Full year)
3rd year = ₹ 20,000 (Half year)

In the books of Gobinda Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2014 March 31	Employee Compensation Expense A/c Dr.		40,000	
	To Employee Stock Option Outstanding A/c			40,000
	(Being compensation expense recognised in respect of 1,000 options granted to employees at a discount of ₹ 100 each, amortised on straight line basis over $2^1/_2$ years)			
"	Statement of Profit and Loss Dr.		40,000	
	To Employee Compensation Expense A/c			40,000
	(Being the compensation expenses of the year transferred to Statement of Profit and Loss)			
2015 March 31	Employee Compensation Expense A/c Dr.		40,000	
	To Employee Stock Option Outstanding A/c			40,000
	(Being compensation expense recognised in respect of 1,000 options granted to employees at a discount of ₹ 100 each, amortised on straight line basis over $2^1/_2$ years)			
"	Statement of Profit and Loss Dr.		40,000	
	To Employee Compensation Expense A/c			40,000
	(Being the compensation expense of the year transferred to Statement of Profit and Loss)			
2016 March 31	Employee Compensation Expense A/c Dr.		20,000	
	To Employee Stock Option Outstanding A/c			20,000
	(Being compensation expense recognised in respect of 1,000 options granted to employees at a discount of ₹ 100 each, amortised on straight line basis over $2^1/_2$ years)			

"	Statement of Profit and Loss Dr.		20,000	
	To Employee Compensation Expense A/c			20,000
	(Being the compensation expense of the year transferred to Statement of Profit and Loss)			
June 30	Bank A/c (1,000 x ₹ 50) Dr.		50,000	
	Employee Stock Option Outstanding A/c (1,000 x ₹ 100) Dr.		1,00,000	
	To Equity Share Capital A/c (1,000 x ₹ 10)			10,000
	To Securities Premium A/c (1,000 x ₹ 140)			1,40,000
	(Being the exercise of 1,000 options at a price of ₹ 50 per share)			

Illustration 6

PWC Limited granted 1,500 options on 1st April, 2013 at ₹ 80 when the market price was ₹ 160. The vesting period was 3 years. The maximum exercise period was 1 year. All the 1,500 options were exercised by the employees on 30th October, 2016.

Pass necessary journal entries recording the above transactions.

Solution

(i) Value of options = 1,500 × (₹ 160 – ₹ 80) = ₹ 1,20,000.

(ii) Amount to be amortised = ₹ 1,20,000 / 3 = ₹ 40,000 each year.

(iii) **In the books of PWC Ltd.**

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2014	Employee Compensation Expense A/c Dr.		40,000	
March 31	To Employee Stock Option Outstanding A/c			40,000
	(Being compensation expenses recognised in respect of 1,500 options granted to employees at a discount of ₹ 80 each, amortised on straight line basis)			
"	Statement of Profit and Loss Dr.		40,000	
	To Employee Compensation Expense A/c			40,000
	(Being the amount transferred to Statement of Profit and Loss)			
2015	Employee Compensation Expense A/c Dr.		40,000	
March 31	To Employee Stock Option Outstanding A/c			40,000
	(Being compensation expenses recognised in respect of 1,500 options granted to employees)			
"	Statement of Profit and Loss Dr.		40,000	
	To Employee Compensation Expense A/c			40,000
	(Being the amount transferred to Statement of Profit and Loss)			
2016	Employee Compensation Expense A/c Dr.		40,000	
March 31	To Employee Stock Option Outstanding A/c			40,000
	(Being compensation expenses recognised in respect of 1,500 options granted to employees)			
"	Statement of Profit and Loss Dr.		20,000	
	To Employee Compensation Expense A/c			20,000
	(Being the amount transferred to Statement of Profit and Loss)			
Oct 30	Bank A/c (1,500 x ₹ 80) Dr.		1,20,000	
	Employee Stock Option Outstanding A/c Dr.		1,20,000	
	To Equity Share Capital A/c			15,000
	To Securities Premium A/c			2,25,000
	(Being the exercise of 1,500 options at a price of ₹ 80 per share)			

Illustration 7

On 1.4.2013 X Ltd. granted 2,000 shares to the employees under stock option scheme at ₹ 75 (Face Value ₹ 10; Market Value ₹ 165). The company allowed 3 years for vesting the option and 1 year maximum exercise period. Employees exercised all the options on 30.9.2016. Show necessary journal entries.

Solution

(i) Value of options = 2,000 × (₹ 165 – ₹ 75) = ₹ 1,80,000

(ii) Amount to be amortised = ₹ 1,80,000 / 3 = ₹ 60,000 each year.

(iii) **In the books of X Ltd.**

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2014 March 31	Employee Compensation Expense A/c	Dr.		60,000	
	To Employee Stock Option Outstanding A/c				60,000
	(Being compensation expense recognised in respect of 2,000 options granted to employees at a discount of ₹ 90 each, amortised on straight line basis)				
"	Statement of Profit and Loss	Dr.		60,000	
	To Employee Compensation Expense A/c				60,000
	(Being the amount transferred to Statement of Profit and Loss)				
2015 March 31	Employee Compensation Expense A/c	Dr.		60,000	
	To Employee Stock Option Outstanding A/c				60,000
	(Being compensation expense recognised in respect of 2,000 options granted to employees)				
"	Statement of Profit and Loss	Dr.		60,000	
	To Employee Compensation Expense A/c				60,000
	(Being the amount transferred to Statement of Profit and Loss)				
2016 March 31	Employee Compensation Expense A/c	Dr.		60,000	
	To Employee Stock Option Outstanding A/c				60,000
	(Being compensation expense recognised in respect of 2,000 options granted to employees)				
"	Statement of Profit and Loss	Dr.		60,000	
	To Employee Compensation Expense A/c				60,000
	(Being the amount transferred to Statement of Profit and Loss)				
Oct 30	Bank A/c (2,000 x ₹ 75)	Dr.		1,50,000	
	Employee Stock Option Outstanding A/c	Dr.		1,80,000	
	To Equity Share Capital A/c				20,000
	To Securities Premium A/c				3,10,000
	(Being the issue of 2,000 equity shares of ₹ 10 each at a premium of ₹ 155 each as a result of exercising the options)				

Illustration 8

The following particulars in respect of stock options granted by DC Limited are available :

(i) Grant date : 1.4.2014
(ii) Number of Options granted : 12,000
(iii) Market price on 1.4.2014 : ₹ 188 per share
(iv) Exercise price : ₹ 140 per share
(v) Face value : ₹ 100
(vi) Vesting Period : 2 years
(vii) Exercise period : 6 months (30.9.2016)

The following information is also relevant :

(a) On 1.6.2014 : 1,500 options lapsed
(b) On 1.1.2015 : 1,500 options lapsed
(c) On 1.1.2016 : 2,000 options lapsed
(d) On 30.9.2016 : 6,800 options were exercised

You are required to pass necessary journal entries (assuming that the year ends on 31st March).

Solution

(i) Intrinsic value of an option :

Market price	₹ 188 per share
Less: Exercise price	₹ 140 per share
	₹ 48 per share

F.Y. 2014-15

(i) Vested options = 12,000 – (1,500 + 1,500) = 9,000
(ii) Vesting period = 2 years

	₹
(iii) Number of year expired = 1 year	
(iv) Unamortised amount (9,000 × ₹ 48)	4,32,000
Less: Amount amortised $\frac{4,32,000}{2} \times 1$	2,16,000
	2,16,000

F.Y. 2015-16

(i) Vested options = 12,000 – 2,000 = 7,000
(ii) Vesting period = 2 years

	₹
(iii) Number of year expired = 2 years	
(iv) Unamortised amount (7,000 × ₹ 48)	3,36,000
Less: Amount amortised	2,16,000
Amount to be recognised as expenses	1,20,000

F.Y. 2016-17

Options forfeited (7,000 – 6,800) = 200
Value of options forfeited = 200 × ₹ 48 = ₹ 9,600.
Therefore, ₹ 9,600 will be transferred to Capital Reserve.

In the books of DC Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2015 March 31	Employee Compensation Expense A/c	Dr.		2,16,000	
	To Employee Stock Option Outstanding A/c				2,16,000
	(Being compensation expense recognised in respect of 9,000 options granted to employees at a discount of ₹ 48 each)				
"	Statement of Profit and Loss	Dr.		2,16,000	
	To Employee Compensation Expense A/c				2,16,000
	(Being the amount transferred to Statement of Profit and Loss)				
2016 March 31	Employee Compensation Expense A/c	Dr.		1,20,000	
	To Employee Stock Option Outstanding A/c				1,20,000
	(Being compensation expense recognised in respect of 7,000 options granted to employees at a discount of ₹ 48 each))				
"	Statement of Profit and Loss	Dr.		1,20,000	
	To Employee Compensation Expense A/c				1,20,000
	(Being the amount transferred to Statement of Profit and Loss)				
Sept 30	Bank A/c (6,800 x ₹ 140)	Dr.		9,52,000	
	Employee Stock Option Outstanding A/c	Dr.		3,26,400	
	To Equity Share Capital A/c (6,800 x ₹ 100)				6,80,000
	To Securities Premium A/c (6,800 x ₹ 88)				5,98,400
	(Being the issue of 6,800 equity shares of ₹ 100 each at a premium of ₹ 88 each)				
	Employee Stock Option Outstanding A/c	Dr.		9,600	
	To General Reserve A/c				9,600
	(Being the amount transferred to General Reserve Account in respect of 200 options lapsed)				

Illustration 9

HCL grants 1,250 options on 1st April, 2014 at ₹ 80 when the market price is ₹ 200 and the face value is ₹ 10. The vesting period is 3 years. The maximum exercise period is one year. 800 options are exercised on 31st August, 2017. Pass necessary journal entries to record the above transactions and also show Employee Compensation Expense Account and Employee Stock Options Outstanding Account and state how these accounts will be shown in the Balance Sheet.

Solution

(i) Value of options = 1,250 × (₹ 200 – ₹ 80) = ₹ 1,50,000.
(ii) Amount to be amortised = ₹ 1,50,000 / 3 = ₹ 50,000 each year.

(iii) **In the books of HCL Ltd.**

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2015 March 31	Employee Compensation Expense A/c	Dr.		60,000	
	To Employee Stock Option Outstanding A/c				60,000
	(Being compensation expense recognised in respect of 1,250 options granted to employees at a discount of ₹ 120)				
"	Statement of Profit and Loss	Dr.		50,000	
	To Employee Compensation Expense A/c				50,000
	(Being the amount transferred to Statement of Profit and Loss)				
2016 March 31	Employee Compensation Expense A/c	Dr.		50,000	
	To Employee Stock Option Outstanding A/c				50,000
	(Being compensation expense recognised in respect of 1,250 options granted to employee at a discount of ₹ 120 each)				
"	Statement of Profit and Loss	Dr.		50,000	
	To Employee Compensation Expense A/c				50,000
	(Being the amount transferred to Statement of Profit and Loss)				
2017 March 31	Employee Compensation Expense A/c	Dr.		50,000	
	To Employee Stock Option Outstanding A/c				50,000
	(Being compensation expense recognised in respect of 1,250 options granted to employees at a discount of ₹ 120 each)				
"	Statement of Profit and Loss	Dr.		50,000	
	To Employee Compensation Expense A/c				50,000
	(Being the amount transferred to Statement of Profit and Loss)				
Aug 31	Bank A/c (800 x ₹ 80)	Dr.		64,000	
	Employee Stock Option Outstanding A/c	Dr.		96,000	
	To Equity Share Capital A/c				8,000
	To Securities Premium A/c				1,52,000
	(Being the issue of 800 equity shares in respect of ESOS)				
	Employee Stock Option Outstanding A/c	Dr.		54,000	
	To General Reserve A/c				54,000
	(Being the amount transferred to General Reserve Account in respect of 450 options lapsed)				

Dr. **Employee Compensation Expense Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015 Mar 31	To Employee Stock Options Outstanding A/c	50,000	2015 Mar 31	By Statement of Profit and Loss	50,000
2016 Mar 31	To Employee Stock Options Outstanding A/c	50,000	2016 Mar 31	By Statement of Profit and Loss	50,000
2017 Mar 31	To Employee Stock Options Outstanding A/c	50,000	2017 Mar 31	By Statement of Profit and Loss	50,000

Dr. **Employee Stock Options Outstanding Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015 Mar 31	To Balance c/d	50,000	2015 Mar 31	By Employee Compensation Expense A/c	50,000
2016 Mar 31	To Balance c/d	1,00,000	2015 Apr 1	By Balance b/d	50,000
			2016 Mar 31	By Employee Compensation Expense A/c	50,000
		1,00,000			1,00,000
2017 Mar 31	To Balance c/d	1,50,000	2016 Apr 1	By Balance b/d	1,00,000
			2017 Mar 31	By Employee Compensation Expense A/c	50,000
		1,50,000			1,50,000

2017 Aug 31	To Equity Shares Capital A/c To Securities Premium A/c To General Reserve A/c	8,000 88,000 54,000	2017 April 1	By Balance b/d	1,50,000
		1,50,000			1,50,000

Disclosure in the Balance Sheet

Employee Stock Options Outstanding will be shown in the Balance Sheet under 'Reserve and Surplus'.

Employee Stock Purchase Scheme (ESPS)

Employee Stock Purchase Scheme (ESPS) means a scheme under which the company offers shares to employees as part of a public issue or otherwise.

Accounting Treatment of Employee Stock Purchase Scheme (ESPS)

1. In respect of shares issued under an ESPS during any accounting period, the accounting value of the share so issued shall be treated as another form of employee compensation in the financial statements of the company.
2. The accounting value of shares issued under ESPS shall be equal to the aggregate of ***price discount*** over all the shares issued under ESPS. [Price discount means the excess of the market price of the shares on the date of issue over the price at which they are issued under the ESPS.]

Accounting Entries

Cash / Bank Account Dr.
Employee Compensation Expense Account Dr.
  To Equity Share Capital Account
  To Securities Premium Account

Illustration 10

Y Ltd issued 1,000 shares on 1st April, 2017 under ESPs at ₹ 50 when the market price is ₹ 150 and the face value is ₹ 10. Pass necessary journal entries to record the above transactions.

Solution

In the books of Y Ltd
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2017 April 1	Bank A/c (1,000 x ₹ 50) Dr.		50,000	
	Employee Compensation Expense A/c Dr.		1,00,000	
	To Equity Share Capital A/c			10,000
	To Securities Premium A/c			1,40,000
	(Being the issue of 1,000 shares under ESPS at a price of ₹ 50 each when the market price is ₹ 150 each)			

Illustration 11

On 1st April, 2012, a company offered 100 shares to each of its 400 employees at ₹ 25 per share. The employees are given a month to accept the shares. The shares issued under the plan shall be subject to lock-in to transfer for three years from the grant date, i.e., 30th April, 2012. The market price of shares of the company on the grant date is ₹ 30 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 28 per share.

Up to 30th April, 2012, 50% of employees accepted the offer and paid ₹ 25 per share purchased. Normal value of each share is ₹ 10. Record the issue of shares in the books of the company under the aforesaid plan.

[C.A. (IPCC) — May, 2012]

Solution

Number of employees accepting the offer : 400 × 50% = 200.
Total number of shares to be issued : 200 × 100 = 20,000.
Fair value of the option : ₹ 28 – ₹ 25 = ₹ 3.
Total value of options : 20,000 × ₹ 3 = ₹ 60,000.

In the books of ...
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2012	Bank A/c (20,000 x ₹ 25)	Dr.		5,00,000	
April 30	Employees' Compensation Expense A/c	Dr.		60,000	
	To Equity Share Capital A/c (20,000 x ₹ 10)				2,00,000
	To Securities Premium A/c (20,000 x ₹ 18)				3,60,000
	(Being the exercise of option by 200 employees @ 100 shares each)				

KEY POINTS

- No ESOS can be offered to employees of a company unless the shareholders of the company approve ESOS by passing a ***special resolution*** in the general meeting.
- ESOS would be open to all permanent employees of the company working in India or outside India and to the directors of the company.
- The company shall not vary the terms of ESOS in any manner, which may be detrimental to the interest of the employee.
- According to Section 2(37) of the Companies Act, 2013, "employees' stock option" means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.
- Employee Stock Purchase Scheme (ESPS) means a scheme under which the company offers shares to employees as part of a public issue or otherwise.

THEORETICAL QUESTIONS

1. What do you mean by Employee Stock Option Scheme (ESOS) ?
2. State SEBI Guidelines for ESOS.
3. What do you mean by Vesting Period ?
4. What do you mean by Employee Stock Purchase Scheme (ESPS) ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. 'Employee Stock Option' can be offered to :
   A whole time directors of the company only
   B officers of the company only
   C employees of the company only
   D all of the above
2. Employee Stock Option can be offered by passing :
   A a special resolution in the general meeting
   B an ordinary resolution in the general meeting
   C a resolution in the board meeting
   D no resolution in any meeting
3. Value of option is equal to :
   A number of option exercised × (market price – exercise price)
   B number of option exercised × (market price – fair price)
   C number of option granted × (market price – exercise price)
   D number of option granted × (market price – fair price)

4. 'Employee Stock Options Outstanding' will appear in the
   A Balance Sheet as a negative item as a part of networth or shareholders' equity
   B Balance Sheet as part of Reserve and Surplus
   C Profit and Loss Account
   D Profit and Loss Appropriation Account
5. An employee who is a promoter or belongs to a promoter group shall
   A be eligible to participate in the 'Employee Stock Purchase Scheme'.
   B not be eligible to participate in the 'Employee Stock Purchase Scheme'
   C be eligible to participate in the 'Employee Stock Purchase Scheme' if it has been approved by the Board of Directors.
   D be eligible to participate in the 'Employee Stock Purchase Scheme' provided it has been approved by the shareholders in the General Meeting.

PRACTICAL QUESTIONS

1. Modern Bio-tech Ltd. granted 4,000 options to employees and directors on 1st April, 2013 asnd ₹ 150 when the market price was ₹ 300. Vesting period is 3 years.
   You are required to :
   (i) Calculate the value of options.
   (ii) Calculate the amount to be amortised every year.
   (iii) Pass necessary journal entries for the year 2013-14, 2014-15 and 2015-16.
2. On 1st April, 2013 CTS Ltd. granted 10,000 shares to employees and directors under stock option scheme at ₹ 100 (face value ₹ 10 and market value ₹ 130). The vesting period was three years. The maximum exercise period was 1 year. All the options were exercised by the employees on 30th November, 2016. You are required to pass necessary journal entries for recording the transactions.
3. L&T Ltd. grants 5,000 options on 1st April, 2013 at ₹ 240 when the market price was ₹ 300 and the face value was ₹ 10. The vesting period was three years.
   The maximum exercise period was one year. 500 unvested options were lapsed on 1st May, 2014, 4,500 options were exercised on 31st March, 2017.
   You are required to pass necessary journal entries to record the transactions :
   (i) Show Employee Compensation Expense Account and Employee Stock Option Outstanding Account.
   (ii) Show extract of the Balance Sheet for the relevant items.
4. M.H.K. Ltd. issued 5,000 equity shares on 1st April, 2017 under Employees Stock Purchase Scheme at ₹ 100 when the market price was ₹ 170 and face value was ₹ 10.
   Pass journal entries to record the above transactions.
5. A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2016 it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130.
   The options were to be exercised between 16th December, 2016 and 15th March, 2017.
   The employees exercised their options for 9,500 shares only, the remaining options lapsed. The company closes its books on 31st March every year.
   Show Journal Entries.
6. X Co Ltd. has its share capital divided into equity shares of ₹ 10 each. On 1.10.2008 it granted 20,000 employees stock options at ₹ 50 per share, when the market price was ₹ 120 per share. The options were to be exercised between 10th December, 2008 and 31st March, 2009.
   The employees exercised their options for 16,000 shares only and the remaining options lapsed. The company closes its books on 31st March every year.
   Show journal entries (with narration) as would appear in the books of the Company up to 31st March, 2009.
   [C.A. (IPCC) — November, 2009]
7. A Company has its share capital divided into shares of ₹ 10 each. On 1.4.2010, it granted 5,000 employees stock option at ₹ 50, when the market price was ₹ 140.
   The options were to be exercised between 1.12.2010 and 28.2.2011.
   The employees exercised their options for 4,800 shares only; remaining options lapsed.
   Pass the necessary journal entries for the year ended 31.3.2011 with regard to employees' stock options.
   [C.A. (IPCC) — November, 2011]

8. G Ltd. grants 100 share options to each of its 690 employees. Each grant containing condition in the employees of G Ltd. as :
   I) Working over the next 4 years.
   ii) It is estimated that 30% of employees will leave during 4 years period.
   iii) Hence forfeit the right of share option.
   (a) What will be the amnount of expenses to be recognised during vesting period.
   (b) Work out the amount of securities premium.
   (c) Give the journal entry of the exercise period.
   N.B. The fair value of each option is ₹ 15.
9. Virtual Limited granted on 1st April, 2011, 1,00,000 Employees Stock Options at ₹ 40, when the market price was ₹ 60. These options will vest at the end of year 1, if the earnings of Virtual Limited is more than 15% or it will vest at the end of the year 2, if the average earnings of two years is more than 12% or lastly it will vest at the end of the third year, if the average earnings of 3 years will be 9% or more. 6,000 unvested options lapsed on 31st March, 2012. 6,500 unvested options lapsed on 31st March, 2013 and finally 3,000 unvested options lapsed on 31st March, 2014. The earnings of Virtual Limited was as follows :

Year ended on	Earnings in %
31.3.2012	13%
31.3.2013	9%
31.3.2014	7%

Employees exercised for 85,000 stock options which vested in them at the first opportunity and the balance options were lapsed. Pass necessary Journal entries and show the necessary working.

[C.A. — Adapted]

10. On 1st April, 2013 X Limited granted 2,000 shares to the employees under stock option scheme at ₹ 75 each (face value ₹ 10 and market value ₹ 165). The company allowed 3 years for vesting the option and 1 year maximum exercise period. The employees exercised all the options on 30th September, 2016.
    Show the necessary journal entries.
11. Beta Limited granted 1,000 options at ₹ 40 to its employees under employee stock option scheme. The face value of each option was ₹ 10 and its market price at that time was ₹ 120. The vesting period is 2 years and 1 year maximum exercise period. All the employees exercised their options fully.
    You are required to pass necessary journal entries to record the above transactions.

[C.U.B.Com. (Hons.) — Adapted]

Guide to Answer

Multiple Choice

1. D; 2. A; 3. C; 4. B; 5. B.

Practical Questions

1. **Value of options — ₹ 6,00,000.**
   Amount to be amortised every year } ₹ 6,00,000 / 3 = ₹ 2,00,000.
2. **Value of options — ₹ 3,00,000**
   Amount to be amortised every year } ₹ 3,00,000 / 3 = ₹ 2100,000.
   Securities Premium ₹ 12,00,000.
   Cash received ₹ 10,00,000.
3. **Value of options — ₹ 5,000 × (300 – 240) = ₹ 3,00,000.**
   Amount to be amortised every year } ₹ 3,00,000 / 3 = ₹ 1,00,000.
   Securities Premium = ₹ 4,500 × (300 – 10) = ₹ 13,05,000.
5. **Amount charged to Statement of Profit and Loss ₹ 8,55,000 in respect of employee compensation expenses.**
6. **(i) Total value of options : ₹ 14,00,000.**
   (ii) Amount charged to Statement of Profit and Loss on 31st March, 2009 : ₹ 11,20,000.
7. **(i) Total value of options : ₹ 4,50,000.**
   (ii) Amount charged to Statement of Profit and Loss on 31st March, 2011 : ₹ 4,32,000.
8. **Fair Value of options granted = 1,24,200 × ₹ 15 = 18,63,000.**
   Fair Value of the vested options = ₹ 18,63,000 × 70% = ₹ 13,11,100.
   Vesting Period : 4 years.
   Amount of compensation expense to be recognised every year = ₹ 13,11,100 ÷ 4 = ₹ 3,27,775.

9. Amount charged to Statement of Profit and Loss.
On 31st March, 2012 : ₹ 6,26,666.
On 31st March, 2013 : ₹ 5,53,334.
On 31st March, 2014 : ₹ 5,30,000.
Amount transferred to General Reserve : ₹ 10,000.
Cash received : ₹ 39,00,000.
Share Capital : ₹ 50,000.
Securities Premium : ₹ 42,50,000

10. Value of option — ₹ 1,80,000.
Amount to be treated as expense in each year — ₹ 60,000.

11. Value of options — ₹ 80,000.
Amount to be treated as expense in each year — ₹ 40,000.

4

Buy Back of Shares

Introduction

Buy-back is a process by which a cash-rich company purchases and cancells some of its outstanding equity shares. The announcement of buy-back can be a good news for the shareholders who want to sell their shares as the company in general offer more price than the prevailing market price. This can be a good thing for the shareholders who are not interested to sell their shares because they will get more portion of the earning and wealth of the company.

All successful companies go for buy-back of shares as it is a low-risk strategy to use surplus cash. The company can use surplus cash for developing a 'new product' but it can be very risky. If the product is not successful, then the hard earned cash goes down the drains. Share buy-back, however, allow the company to invest in themselves establishing the confidence of the management in the company.

However, before going for buy-back, the company should look into the following matters :

1. The company should not buy its own shares when the market is 'hot' and share are 'over-valued'.
2. The company should not buy-back shares after borrowing money from market at high rate of interest.
3. The company should go for buy-back when the management feels that the price of the shares is far too low than it should be.

Buy back of shares were introduced first time in India in the year 1999 through the Companies (Amendment) Act, 1999. Buy back of shares is just the opposite of raising capital through issue of shares. It is a process of capital restructuring which allows a company to purchase its own shares from the existing equity shareholders.

Objectives of Buy Back

The objectives of buy back are to :

(1) increase the EPS after the shares are bought back. The EPS of the company will go up assuming there is no reduction in the earnings of the company;

(2) increase promoters' holding in the company — the percentage of holding of the promoters will rise because their shares are not available for buy back;

(3) increase the market price of the share — the buy back announcement helps to increase the market price of the company's share because the buy back price is more than the market price;

(4) send a signal among the investors about the company's financial strength and prospects;

(5) help the company to distribute its surplus cash among the investors; and

(6) change the capital structure — buyback of shares helps a company to restructure its capital base. In other words, the proportion of different instruments in the capital structure can be changed with the help of buy back.

Benefits of Buy Back

A company, which is buying back its own share, may derive the following benefits :

(1) It helps to increase the EPS and if the company maintains the same dividend payout ratio, dividend per share will also go up.

(2) The market price of the share will also go up. Therefore, the shareholders who have not participated in the buy back programme are also expected to gain from capital appreciation.

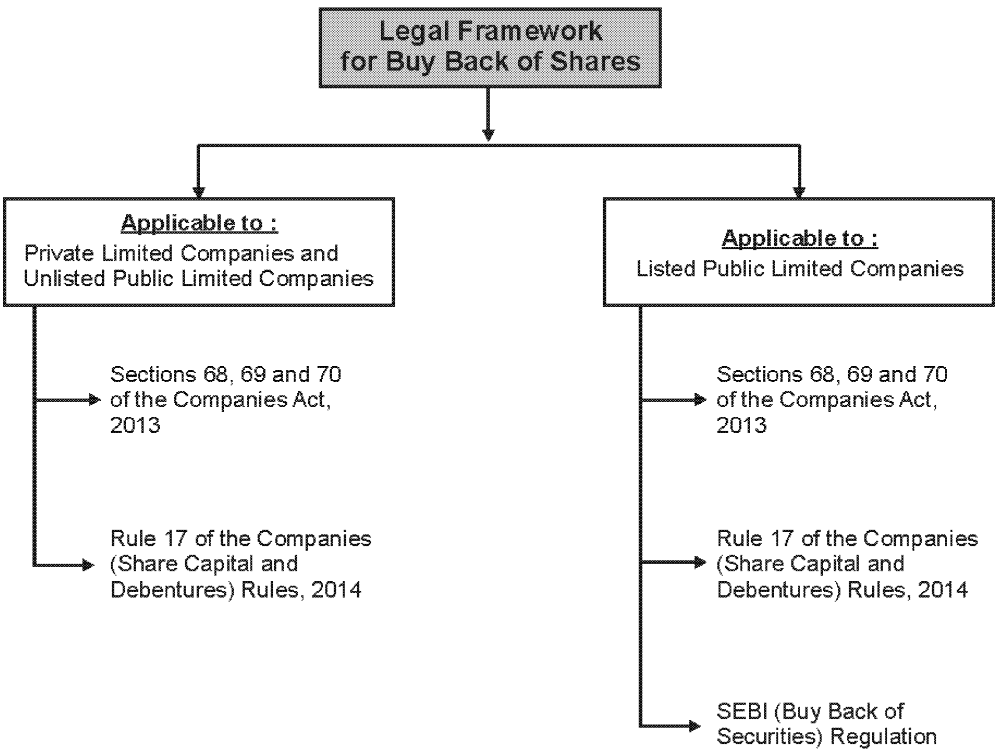
(3) When the company has a surplus fund and the company does not have a profitable venture where it can invest this money, it can return money to the shareholders. It also helps the company to concentrate on its core area of business and does not resort to diversification in non-core areas.

(4) Promoters can increase their stake in the company through buy back of shares. This is necessary for the promoter group when there is a threat of takeover from others.

(5) Buy back is a useful tool to enhance shareholders' value. After buy back, there is a reduction in the number of shares and therefore, EPS will go up.

(6) At the initial stage of the business when a company does not earn sufficient amount of profit, it has to depend more on the equity capital in order to avoid loss. Later on when the company's profitability goes up, it can restructure its capital base by buying back its own shares and issuing debt.

(7) For illiquid scrips, buy back will provide an exit route to the investors.



It is clear from the above diagram that Sections 68, 69 and 70 plus Rule 17 are common to all Companies (listed, unlisted and private). However, SEBI Regulations are applicable to listed companies only.

Buy Back of Securities Under Companies Act, 2013

1. Sources of Buy Back

As per the provisions of Section 68(1) of the Companies Act, 2013 a company may purchase its own shares or other specified securities (e.g., Employees' Stock Option or other securities as may be notified by the Central Government) out of :

(i) its free reserves;
(ii) securities premium; or
(iii) the proceeds of the issue of any shares or other specified securities.

It is to be noted that no buy back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the ***same kind of shares*** or ***same kind of other specified securities.***

For example, Preference shares can be issued for buy back of equity shares. However, equity shares can not be issued for the purpose of buy back of equity shares.

Meaning of 'Free Reserves'

Section 2(43) has defined 'free reserves' as follows :

"Free reserves means such reserves which as per the latest ***audited*** Balance Sheet of a company, are available for distribution as dividend :

Provided that—

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whatever shown as a reserve or otherwise, or
(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in Profit and Loss Account on measurement of the asset or the liability at fair value;

shall not be treated as free reserves.

In this respect, the 'Explanation II' of Section 68 is very important. It has been stated that for the purpose of this Section, 'free reserves' includes Securities Premium Account.

Meaning of Securities Premium Account

By virtue of the Companies (Amendment) Act, 1998, the expression "Share Premium Account" has been substituted by "Securities Premium Account". It should be remembered that, for all practical purposes, premium can be collected only from shareholders. Collecting premium from debentureholders is inconceivable. This is because, debentureholders often demand and get premium on redemption or demand and get discount at the time of issue in order to, in either case, enhance their average returns. Since it is a free reserve, it can be used as available funds for buy back of shares.

Meaning of Proceeds of an Earlier Issue

Buy back of shares is not allowed out of fresh issue of equity shares, since fresh issue of shares for buying back does not make any financial sense. However, buy back is allowed utilising proceeds from issue of preference shares. Buy back is allowed by utilising proceeds from issue of hybrid instruments (e.g. convertible debentures), bonds, secured and unsecured loans etc.

2. Basic Conditions and Limits for Buy Back of Shares

As per the provision of Section 68(2) of the Companies act, 2013, no company shall purchase its own shares or other specified securities, unless —

(a) the buy back is authorised by its articles;
(b) a special resolution has been passed at a general meeting of the company authorising the buy back

It should be noted that the special resolution will not be required when :

(i) The buy back is not exceeding 10% of the total equity capital and free reserves of the company; and

(ii) Such buy back has been authorised by the Board by means of a resolution passed at its meeting;

(c) the buy back is ***twenty-five per cent*** or less than the aggregate of paid-up capital and free reserves of the company.

In this respect, it should be noted that buy back of equity shares in any financial year should not exceed 25% of the total paid-up equity share capital in that financial year.

(d) the post buy back debt-equity ratio should not exceed 2 : 1. In some special cases, the Central Government, by order, may allow higher debt-equity ratio.

Debts = Aggregate of secured and unsecured debts owed by the company post buy back.
Equity = Aggregate of the paid-up capital and its free reserves.

(e) all the shares or other specified securities for buy back are ***fully paid-up***.

(f) If the shares and other specified securities are listed, buy back will be as per SEBI Regulation in this regard.

(g) the buy back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with such rules as may be prescribed.

Provided that no offer of buy back under this sub-section shall be made within a period of ***one year*** reckoned from the date of the closure of the preceding offer of buy back, if any.

3. Explanatory Statement

The notice of the meeting at which the special resolution is proposed to be passed shall be accompanied by an explanatory statement stating —

(a) a full and complete disclosure of all material facts;

(b) the necessity for the buy back;

(c) the class of shares or securities intended to be purchased under the buy back;

(d) the amount to be invested under the buy back; and

(e) the time limit for completion of buy back.

4. Time Limit for Buy Back

Every buy back shall be completed within a period of ***one year*** from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board.

5. Alternative Ways for Buy Back

The buy back may be —

(a) from the existing shareholders or security holders on a proportionate basis;

(b) from the open market;

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

6. Declaration of Solvency by Directors

Where a company proposes to buy back its own shares or other specified securities, it shall, before making such buy back, file with the Registrar and the Securities and Exchange Board, a ***declaration of solvency*** signed by ***at least two directors of the company***, one of whom shall be the managing director, if any, in such form as may be prescribed and verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a rsult of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of ***one year*** from the date of declaration adopted by the Board.

7. Extinguishment of Share Certificate

Where a company buys back its own shares or other specified securities, it shall extinguish and physically destroy the shares or securities so bought back within ***seven days*** of the last date of completion of buy back.

8. Restriction on Issue of Shares Within 6 Months

Where a company completes a buy back of its shares or other specified securities under this section, it shall not make a further issue of the same kind of shares or other securities including allotment of new shares or other specified securities within a period of ***six months*** except by way of a bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock options schemes, sweat equity or conversion of preference shares or debentures into equity shares.

9. Maintenance of Register

Where a company buys back its shares or other specified securities under this section, it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or secuirities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.

10. Filing of Return to Registrar and SEBI

A company shall, after the completion of the buy back under this section, file with the Registrar and the Securities and Exchange Board a return containing such particulars relating to the buy back within thirty days of such completion, as may be prescribed.

Provided that no return shall be filed with the Securities and Exchange Board of India (SEBI) by a company whose shares are not listed on any recognised stock exchange.

11. Penalty

If a company makes any default in complying with the provisions of this section or any regulation made by the SEBI, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extent to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

Creation of Capital Redemption Reserve

Section 69 of the Companies Act, 2013 states that :

(1) Where a company purchases its own shares out of free reserves or Securities Premium Account, a sum cequal to the nominal value of the shares so purchased shall be transferred to the cpaital redemption reserve account and details of such transfer shall be disclosed in the Balance Sheet.

(2) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Prohibition of Buy Back in Certain Circumstances

Section 70 of the Companies Act, 2013 states that —

(1) No company shall directly or indirectly purchase in own shares or other specified securities —
- (a) through any subsidiary company including its own subsidiary companies;
- (b) through any investment company or group of investment companies; or
- (c) if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of the Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company :

Provided that the buy back is not prohibited, if the default is remedied and a period of ***three years*** has lapsed after such default ceased to subsist.

(2) No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of Section 92, 123, 127 and 129.
It should be noted that :
Section 92 deals with Annual Return
Section 123 deals with Declaration and Payment of Dividend
Section 127 deals with Failure to Pay Dividend
Section 129 deals with Failue to give True and Fair Statement

Rule 17 of the Companies (Share Capital and Debentures) Rules, 2014

In ***relation to buy back of shares or other securities***, Rule 17 states that :

Unless stated otherwise, the following norms shall be complied with by the ***private*** companies and ***unlisted public*** companies for buy back of their securities.

1. Explanatory Statement

The explanatory statement to be annexed to the notice of the general meeting pursuant to Section 102 shall contain the following disclosures, namely —

(a) the date of the board meeting at which the proposal for buy back was approved by the board of directors of the company;
(b) the objective of the buy back;
(c) the class of shares or other securities intended to be purchased under the buy back;
(d) the number of securities that the company proposes to buy back;
(e) the method to be adopted for the buy back;
(f) the price at which the buy back of shares or other securities shall be made;
(g) the basis of arriving at the buy back price;
(h) the maximum amount to be paid for the buy back and the sources of funds from which the buy back would be financed;
(i) the time limit for the completion of buy back;
(j) (i) the aggregate shareholding of the promoters and of the directors of the promoter, where the promoter is a company and of the directors and key managerial personnel as on the date of the notice convening the general meeting;
(ii) the aggregate number of equity shares purchased or sold by persons mentioned in sub-clause (i) during a period of twelve months preceding the date of the board meeting at which the buy back was approved and from that date till the date of notice convening the general meeting;
(iii) the maximum and minimum price at which purchases and sales referred to in sub-clause (ii) were made along with the relevant date;
(k) if the persons mentioned in sub-clause (i) of clause (j) intend to tender their shares for buy back—
(i) the quantum of shares proposed to be tendered;
(ii) the details of their transactions and their holdings for the last twelve months prior to the date of the board meeting at which the buy back was approved including information of number of shares acquired, the price and the date of acquisition;
(l) a confirmation that there are no defaults subsisting in repayment of deposits, interest payment thereon, redemption of debentures or payment of interest thereon or redemption of preference shares or payment of dividend due to any shareholder, or repayment of any term loans or interest payable thereon to any financial institution or banking company;
(m) a confirmation that the Board of directors have made a full enquiry into the affairs and prospects of the company and that they have formed the opinion —
(i) that immediately following the date on which the general meeting is convened there shall be no grounds on which the company could be found unable to pay its debts;
(ii) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be

available to the company during that year, the company shall be able to meet its liabilities as and when they fall due and shall not be rendered insolvent within a period of one year from that date; and

(iii) the directors have taken into account the liabilities(including prospective and contingent liabilities), as if the company were being wound up under the provisions of the Companies Act, 2013

(n) a report addressed to the Board of directors by the company's auditors stating that —

(i) they have inquired into the company's state of affairs;

(ii) the amount of the permissible capital payment for the securities in question is in their view properly determined;

(iii) that the audited accounts on the basis of which calculation with reference to buy back is done is not more than six months old from the date of offer document; and

(iv) the Board of directors have formed the opinion as specified in clause (m) on reasonable grounds and that the company, having regard to its state of affairs, shall not be rendered insolvent within a period of one year from that date.

2. Filing of Letter of Offer with the ROC

The company which has been authorized by a special resolution shall, before the buy-back of shares, file with the Registrar of Companies a letter of offer in Form No. SH.8, along with the fee:

Provided that such letter of offer shall be dated and signed on behalf of the Board of directors of the company by not less than two directors of the company, one of whom shall be the managing director, where there is one.

3. Declaration of Solvency by Directors

The company shall file with the Registrar, along with the letter of offer, and in case of a listed company with the Registrar and the Securities and Exchange Board, a declaration of solvency in Form No. SH.9 along with the fee and signed by at least two directors of the company, one of whom shall be the managing director, if any, and verified by an affidavit as specified in the said Form.

4. Time Limit for Despatch of Offer Letter

The letter of offer shall be dispatched to the shareholders or security holders immediately after filing the same with the Registrar of Companies but not later than ***twenty days*** from its filing with the Registrar of Companies.

5. Offer Period

The offer for buy-back shall remain open for a period of ***not less than fifteen days*** and ***not exceeding thirty days*** from the date of dispatch of the letter of offer.

6. Proportionate Buy Back in Case of Excess Offer by the Shareholders

In case the number of shares or other specified securities offered by the shareholders or security holders is more than the total number of shares or securities to be bought back by the company, the acceptance per shareholder shall be on proportionate basis out of the total shares offered for being bought back.

7. Verification of Offer and Communication to Shareholders

The company shall complete the verifications of the offers received within fifteen days from the date of closure of the offer and the shares or other securities lodged shall be deemed to be accepted unless a communication of rejection is made within twenty one days from the date of closure of the offer.

8. Opening of A Separate Bank Account

The company shall immediately after the date of closure of the offer, open a separate bank account and deposit therein, such sum, as would make up the entire sum due and payable as consideration for the shares tendered for buy-back in terms of these rules.

9. Time Limit for Payment of Consideration / Return of Share Certificate

The company shall within ***seven days*** of the time specified in sub-rule (7)—

(a) make payment of consideration in cash to those shareholders or security holders whose securities have been accepted; or

(b) return the share certificates to the shareholders or security holders whose securities have not been accepted at all or the balance of securities in case of part acceptance .

10. Miscellaneous Conditions

The company shall ensure that—

(a) the letter of offer shall contain true, factual and material information and shall not contain any misleading information and must state that the directors of the company accept the responsibility for the information contained in such document;

(b) the company shall not issue any new shares including by way of bonus shares from the date of passing of special resolution authorizing the buy-back till the date of the closure of the offer under these rules, except those arising out of any outstanding convertible instruments;

(c) the company shall confirm in its offer the opening of a separate bank account adequately funded for this purpose and to pay the consideration only by way of cash;

(d) the company shall not withdraw the offer once it has announced the offer to the shareholders;

(e) the company shall not utilize any money borrowed from banks or financial institutions for the purpose of buying back its shares; and

(f) the company shall not utilize the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities for the buy-back.

11. Maintenance of Register

(a) The company, shall maintain a register of shares or other securities which have been bought-back in ***Form No. SH.10***.

(b) The register of shares or securities bought-back shall be maintained at the registered office of the company and shall be kept in the custody of the secretary of the company or any other person authorized by the board in this behalf.

(c) The entries in the register shall be authenticated by the secretary of the company or by any other person authorized by the Board for the purpose.

12. Filing of Return with the Registrar and SEBI

The company, after the completion of the buy-back under these rules, shall file with the Registrar, and in case of a listed company with the Registrar and the Securities and Exchange Board of India, a return in the ***Form No. SH.11*** along with the fee .

13. Compliance Certificate by the Directors

There shall be annexed to the return filed with the Registrar in ***Form No. SH.11***, a certificate in Form No. SH.15 signed by two directors of the company including the managing director, if any, certifying that the buy-back of securities has been made in compliance with the provisions of the Act and the rules made thereunder.

SEBI (Buy Back of Securities) Regulation, 1998*

Applicability

(1) These regulations shall be applicable to buy back of shares or other specified securities of a company ***listed*** on a stock exchange.

(2) A company listed on a stock exchange shall not buy back its shares or other specified securities so as to delist its shares or other specified securities from the stock exchanges.

*As amended upto 08.08.2013

Methods of Buy Back

(1) A company may buy back its shares or other specified securities by any one of the following methods—

(a) from the existing security-holders on a proportionate basis through the tender offer;

(b) from the open market through —

(i) book-building process

(ii) stock exchange

(c) from odd-lot holders

Provided that 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.

(2) A company shall not buy back its shares or other specified securities from any person through negotiated deals, whether on or of the stock exchange or through spot transactions or through any private arrangement.

(3) Any person or an insider shall not deal in securities of the company on the basis of unpublished information relating to buy back of shares or other specified securities of the company.

(4) A company shall not make any offer of buy back within a period of ***one year*** reckoned from the date of closure of the preceding offer of buy back, if any.

Buy Back from Existing Security-holders (Through Tender Offer)

A company may buy back its shares or other specified securities from its existing security-holders on a proportionate basis in accordance with the provisions of this Chapter.

Provided that fifteen per cent of the number of securities which the company proposes to buy back or number of securities entitled as per their shareholding, whichever is higher, shall be reserved for small shareholders.

Offer Procedure

(1) A company making a buy back offer shall announce a ***record date*** for the purpose of determining the entitlement and the names of the security holders, who are eligible to participate in the proposed buy back offer.

(2) The letter of offer along with the tender form shall be despatched to the security holders who are eligible to participate in the buy back offer, not later than ***five working days*** from the receipt of communication of comments from the Board.

(3) The date of the opening of the offer shall be not later than ***five working days*** from the date of despatch of letter of offer.

(4) The offer for buy back shall remain open for a period of ***ten working days.***

(5) The company shall accept shares or other specified securities from the security holders on the basis of their entitlement as on record date.

(6) The shares proposed to be bought back shall be divided into two categories : (a) reserved category for small shareholders; and (b) the general category for other shareholders, and the entitlement of a shareholder in each category shall be calculated accordingly.

(7) After accepting the shares or other specified securities tendered on the basis of entitlement, shares or other specified securities left to be bought back, if any, in one category shall first be accepted, in proportion to the shares or other specified securities tendered over and above their entitlement in the offer by security holders in that category and thereafter from security holders who have tendered over and above their entitlement in other category.

Payment to Security-holders

(1) The company shall immediately after the date of closure of the offer open a special account with a banker to an issue registered with the Board and deposit therein, such sum as would, together with ninety per cent of the amount lying in the Escrow Account make-up the entire sum due and payable as consideration for buy back in terms of these regulations and for this purpose, may transfer the funds from the Escrow Account.

(2) The company shall complete the verifications of offers received and make payment of consideration to those security holders whose offer has been accepted or return the shares or other specified securities to the security holders within seven working days of the closure of the offer.

Extinguishment of Certificate

(1) The company shall extinguish and physically destroy the security certificates so bought back in the presence of a Registrar to issue or the Merchant Banker and the Statutory Auditor within fifteen days of the date of acceptance of the shares or other specified securities.
Provided that the company shall ensure that all the securities bought back are extinguished within seven days of the last date of completion of buy back.

(2) The shares or other specified securities offered for buy back if already dematerialsed shall be extinguished and destroyed in the manner specified under the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996, and the bye-laws framed thereunder.

(3) (a) the company shall, furnish a certificate to the Board certifying compliance as specified in sub-regulation (1) and duly certified and verified by —
(i) the registrar and whenever there is no registrar by the merchant banker;
(ii) two directors of the company, one of whom shall be a managing director, where there is one;
(iii) the statutory auditor of the company.

(b) The certificate required under clause (a) shall be furnished to the Board on a monthly basis by the seventh day of the month succeeding the month in which the securities certificates are extinguished and destroyed.

(4) The company shall furnish, the particulars of the security certificates extinguished and destroyed under sub-regulation (1), to the stock exchanges where the shares of the company are listed on a monthly basis by the seventh day of the month succeeding the month in which the securities certificates are extinguished and destroyed.

(5) The company shall maintain a record of security certificates which have been cancelled and destroyed.

Odd-lot Buy Back

The provisions pertaining to buy back through tender offer as specified in this Chapter shall be applicable *mutatis mutandis* to odd-lot shares or other specified securities.

Buy Back from the Open Market

A company intending to buy back its shares or other specified securities from the open market shall do in accordance with the provisions of this Chapter.

The buy back of shares or other specified securities from the open market may be in any one of the following methods :

(a) through stock exchange
(b) book building process

The company shall ensure that at least fifty per cent of the amount earmarked for buy back is utilised for buying back shares or other specified securities.

(a) Buy Back Through Stock Exchange

A company shall buy back its shares or other specified securities through the stock exchange as provided hereunder :

(a) The special resolution or the resolution passed by the Board of Directors at its meeting shall specify the maximum price at which the buy back shall be made;

(b) The buy back of the shares or other specified securities ***shall not be made from the promoters or persons in control of the company***;

(c) The company shall appoint a merchant banker and make a public announcement as referred to in regulation 8;

(d) The public announcement shall be made within seven working days from the date of passing the resolution.

(e) Simultaneously with the issue of such public announcement, the company shall file a copy of the public announcement with the Board along with the fees specified in Schedule IV.

(f) The public announcement shall also contain disclosures regarding details of the brokers and stock exchanges through which the buy back of shares or other specified securities would be made;

(g) The buy back shall be made only on stock exchanges having nationwide trading terminals.

(h) The buy back of shares or other specified securities shall be made only through the order matching mechanism except 'all or none' order matching system;

(i) The company shall submit the information regarding the shares or other specified securities bought back, to the stock exchange ***on a daily basis*** in such form as may be specified by the Board and the stock exchange shall upload the same on its official website immediately.

  (ia) The company shall upload the information regarding the shares or other specified securities bought back on its website on a daily basis.

(j) The identity of the company as a purchaser shall appear on the electronic screen when the order is placed.

(k) The buy back offer shall open not later than seven working days from the date of public announcement and shall close within six months from the date of opening of the offer.

Buy Back of Physical Shares or Other Specified Securities

A company shall buy back its shares or other specified securities in physical form through ***open market*** method as provided hereunder :

(a) a separate window shall be created by the stock exchange, which shall remain open during the buy back period, for buy back of shares or other specified securities in ***physical form.***

(b) the company shall buy back shares or other specified securities from eligible shareholders holding physical shares through the separate window specified in clause (a), only after verification of the identity proof and address proof of the broker.

(c) the price at which the shares or other specified securities are bought back shall be the volume weighted average price of the shares or other specified securities bought back, other than in the physical form, during the calendar week in which such shares or other specified securities were received by the broker.

Provided that the price of shares or other specified securities tendered during the first calendar week of the buy back shall be the volume weighted average market price of the shares or other specified securities of the company during the preceding calendar week.

Explanation.— In case no shares or other specified securities were bought back in the normal market during calendar week, the preceding week when the company has last bought back the shares or other specified securities may be considered.

Escrow Account

(1) The company shall, before opening of the offer, create an Escrow Account towards security for performance of its obligations under these regulations, and deposit in Escrow Account 25 per cent of the amount earmarked for the buy back as specified in the resolutions.

(2) The Escrow Account referred to in sub-regulation (1) may be in the form of —

  (a) cash deposited with any scheduled commercial bank; or

  (b) bank guarantee issued in favour of the merchant banker by any scheduled commercial bank.

(3) For such part of the Escrow Account as in the form of a cash deposit with a scheduled commercial bank, the company shall while opening the account, empower the merchant banker to instruct the bank to make payment of the amounts lying to the credit of the Escrow Acount to meet the obligations arising out of the buy back.

(4) For such part of the Escrow Account as is in the form of a bank guarantee :

  (a) the same shall be in favour of the merchant banker and shall be kept valid for a period of thirty days after the closure of the offer or till the completion of all obligations under these regulations, whichever is later.

  (b) the same shall not be returned by the merchant banker till completion of all obligations under the regulations.

(5) Where part of the Escrow Account is in the form of a bank guarantee, the company shall deposit with a scheduled commercial bank, in cash, a sum of at least 2.5 per cent of the total amount earmked for buy back as specified in the regulations referred to in regulation 5 or regulation 5A, as and by way of security for fulfillment of the obligations under the regulations by the company.

(6) The escrow amount may be released for making payment to the shareholders subject to at least 2.5% of the amount earmarked for buy back as specified in the resolutions referred to in regulation 5 or regulation 5A, remaining in the Escrow Account at all points of time.

(7) On fulfilling the obligation specified in sub-regulation (3) of Regulation 14, the amount and the guarantee remaining in the Escrow Account, if any, shall be released to the company.

(8) In the event of non-compliance with sub-regulation (3) of regulation 14, except in cases where —

(a) volume weighted average market price (VWAMP) of the shares or other specified securities of the company during the buy back period was higher than the buy back price as certified by the merchant banker based on the inputs provided by the stock exchanges.

(b) inadequate sell orders despite the buy orders placed by the company as certified by the merchant banker based on the inputs provided by the stock exchanges.

(c) such circumstances which were beyond the control of the company and in the opinion of the Board merit consideration.

the Board may direct the merchant banker to forfeit the Escrow Account, subject to a maximum of 2.5 per cent of the amount earmarked for buy back as specified in the resolutions referred to in regulations 5 or 5A.

(9) In the event of forfeiture for non-fulfillment of obligations specified in sub-regulation (8), the amount forfeited shall be deposited in the Investor Protection and Education Fund of Securities and Exchange Board of India.

Extinguishment of Certificates

(1) Subject to the provisions of sub-regulation (2) and sub-regulation (3), the provisions of regulation 12 pertaining to extinguishment of certificates shall be applicable mutatis mutandis.

(2) The company shall complete the verification of acceptances within fifteen days of the pay-out.

(3) The company shall extinguish and physically destroy the securities certificates so bought back during the month in the presence of a merchant banker and the statutory auditor, on or before the fifteenth day of the succeeding month.

Provided that the company shall ensure that all the securities bought back are extinguished within ***seven days*** of the last date of completion of buy back.

Buy Back through Book Building

(1) A company may buy back its shares or other specified securities through the book-building process as provided hereunder:

(a) The special resolution or the resolution passed by the Board of Directors at its meeting, shall specify the maximum price at which the buy back shall be made.

(b) The company shall appoint a merchant banker and make a public announcement.

(c) The public announcement shall be made at least 7 days prior to the commencement of buy back.

(d) Subject to the provisions of sub-clauses (i) and (ii) the provisions of regulation 10 shall be applicable :

(i) The deposit in the Escrow Account shall be made before the date of the public announcement.

(ii) the amount to be deposited in the Escrow Account shall be determined with reference to the maximum price as specified in the public announcement.

(e) A copy of the public announcement shall be filed with the Board within two days of such announcement along with the fees as specified in Schedule IV.

(f) The public announcement shall also contain the detailed methodology of the book-building process, the manner of acceptance, the format of acceptance to be sent by the security holders pursuant to the public announcement and the details of bidding centres.

(g) The book-building process shall be made through an electronically linked transparent facility.

(h) The number of bidding centres shall ***not be less than thirty*** and there shall be at least one electronically linked computer terminal at all the bidding centres.

(i) The offer for buy back shall remain open to the security holders for a period ***not less than fifteen days*** and ***not exceeding thirty days.***

(j) The merchant banker and the company shall determine the buy back price based on the acceptances received.

(k) The final buy back price, which shall be the highest price accepted shall be paid to all holders whose shares or other specified securities have been accepted for buy back.

(2) The provisions of sub-regulation (2) of regulation 11 pertaining to verification of acceptances and the provisions of regulation 11 pertaining to opening of special account and payment of consideration shall be applicable ***mutatis mutandis.***

Extinguishment of Certificates

The provisions of regulation 12 pertaining to extinguishment of certificates shall be applicable ***mutatis mutandis***.

Real Life Focus

Indian Firms Buy Back ₹ 4,426 Crore Shares in FY14

Indian firms bought back shares worth over ₹ 4,400 crore from public in 2013-14, achieving just 78 per cent of the target, according to a report by Prime Database.
31 buyback offers were concluded in 2013-14, with a total acquired sum of ₹ 4,426 crore, while the amount on offer was ₹ 5,704 crore.
The largest buyback completed was by state-run NHPC for ₹ 2,368 crore.
Out of 31 buyback offers, 24 were through the stock exchange route, while the rest were via the tender offer.

Source : NDTVProfit.com

Bharati Airtel to Buy Back Fully Paid-Up Shares Worth ₹ 1,434 Crore

The Board of Bharati Airtel on April 27, 2016 approved the proposal to buy back the fully paid equity shares of face value of ₹ 5 each from the shareholders on a proporate basis through a tender offer.
"The buy-back shall be up to an aggregate amount not exceeding ₹ 1,434 crore at a price of ₹ 400 per equity share translating into approximately 3,58,50,000 equity shares, representing 0.90 per cent of the total paid-up equity share capital of the company" Airtel said in its earlier statement.

Mphasis Board Approves ₹ 1,103 crore Buyback Plan

IT service provider Mphasis said its board has approved a share buyback plan worth up to ₹ 1,103 crore.
"The board of directors of the company at its meeting, approved a proposal for buyback of equity shares from all existing shareholders of company on a proportionate basis through the tender offer method, at a maximum price of ₹ 635 per equity share aggregating to an amount not exceeding ₹ 1,1030 million."

Source : Moneycontrol.com 16,th April, 2016

Bengaluru-based Sasken Communication will Buyback around 41.57 Lakh Shares through a Tender Offer

The board has approved this buyback which involves 41.57 lakh shares at ₹ 10 from existing shareholders at a price of ₹ 260 a share. This is payable in cash up to ₹ 108 crore, which is less than 25 per cent of the total paid-up capital and reserves of the company. Sasken shares closed lower by 2.4 per cent at ₹ 247 on BSE.
Currently, about 27,600 small investors hold a 23.67 per cent stake in Sasken and 55 HNIs own 8.82 per cent. FIIs hold a 2.91 per cent stake in the company and domestic funds control 10.57 per cent. Further, the Sasken board has recommended a final dividend of ₹ 4.50 an equity share for FY15, which adds up a dividend of ₹ 27 an equity share of ₹ 10 each.

Source : Hindu Business Line, 23rd April, 2017

Accounting Entries

1. For the amount payable on buy back		
Equity Share Capital Account (nominal value)	Dr.	[Face value]
Reserves (Premium) Account	Dr.	[Extra amount to be paid]
To Equity Shareholders Account		[No. of shares purchased × Agreed price]
2. For the actual payment		
Equity Shareholders Account	Dr.	
To Bank Account		
3. For transfer to capital redemption reserve		
Reserves Account	Dr.	
To Capital Redemption Reserve Account		

Illustration 1

ABC Limited furnished you with the following Balance Sheet as on 31.3.2017 :

Balance Sheet of ABC Limited as at 31st March, 2017

Particulars (1)	Note No. (2)	Amount (₹ in Crore) (3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	100
(b) Reserves and Surplus	(2)	400
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		50
(b) Trade Payables		100
(c) Other Current Liabilities		50
TOTAL		700
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	400
(b) Non-current Investments		—
(2) Current Assets :		
(a) Current Investments		40
(b) Inventories		100
(c) Trade Receivables		100
(d) Cash and Cash Equivalents		60
TOTAL		700

Notes to Accounts :

(1) Share Capital

Particulars	₹ in Crore
Authorised Capital :	
5 Crore Equity Shares of ₹ 10 each	50
15 Crore, 12% Preference Shares of ₹ 10 each	150
	200
Issued, Subscribed and Paid-up Capital :	
2.5 Crore Equity Shares of ₹ 10 each	25
7.5 Crore, 12% Preference Shares of ₹ 10 each	75
	100

(2) Reserve and Surplus

Particulars	₹ in Crore
General Reserve	260
Securities Premium	25
Profit and Loss Account	115
	400

(3) Fixed Assets :

(a) *Tangible Assets*	
Land and Building	250
Plant and Machinery	100
Furniture	50
	400

The company bought back 50 lakh equity shares of ₹ 10 each at ₹ 50 per share.
The payment for this was made out of the bank balance. Pass journal entries to record these transactions.

Solution

ABC Limited
Journal

Date	Particulars		L.F.	Dr. ₹ (Crore)	Cr. ₹ (Crore)
?	Equity Share Capital A/c	Dr.		5	
	Securities Premium A/c	Dr.		20	
	To Equity Shareholders A/c				25
	(Being the amount payable to equity shareholders on buy back of 50 lakhs equity shares of ₹ 10 each @ ₹ 50 each as per Special Resolution No. . . . dated . . .)				
?	Equity Shareholders A/c	Dr.		25	
	To Bank A/c				25
	(Being the equity shareholders paid-off against buy back of shares)				
?	Securities Premium A/c **(See Turotial Note)**	Dr.		5	
	To Capital Redemption Reserve A/c				5
	(Being the creation of capital redemption reserve as per the requirement of the Act)				

Tutorial Note : As per the provision of Section 69 of the Companies Act, 2013 — Where a company purchgases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to Capital Redemption Reserve Account. In this case, face value of shares purchased is ₹ 5 crores. Therefore, ₹ 5 crore is to be transferred to Capital Redemption Reserve Account from Securities Premium Account.

Illustration 2

Delight Ltd. decided to buy back 60,000 of the equity shares of ₹ 10 each at a premium of 25%. For this, it issues 5,000 7.5% Preference Shares of ₹ 100 each at par. The company has ₹ 80,000 in General Reserve, ₹ 1,00,000 in Profit and Loss Account (Cr.), ₹ 1,20,000 in Capital Reserve and ₹ 1,00,000 in security premium. It decided to utilise profits and reserves also. Give Journal Entries assuming that the transactions have been duly carried out.

Solution

In the Books of Delight Ltd
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		5,00,000	
	To 7.5% Preference Share Application A/c				5,00,000
	(Being the application money received on 5,000, 7.5% Preference Shares @ ₹ 100 each)				
	7.5% Preference Share Application A/c	Dr.		5,00,000	
	To 7.5% Preference Share Capital A/c				5,00,000
	(Being the preference share application money transferred to Preference Share Capital Account as per Special Resolution No. ... dated ...)				
	Equity Share Capital A/c	Dr.		6,00,000	
	Securities Premium A/c (Note 1)	Dr.		1,00,000	
	General Reserve A/c (Note 1)	Dr.		50,000	
	To Equity Shareholders A/c				7,50,000
	(Being the amount payable to equity shareholders on buy back of 60,000 equity shares of ₹ 10 each at premium of 25% as per Special Resolution No. ... dated ...)				
	Equity Shareholders A/c	Dr.		7,50,000	
	To Bank A/c				7,50,000
	(Being equity shareholders paid-off against buy back of shares)				
	General Reserve A/c	Dr.		30,000	
	Profit and Loss A/c	Dr.		70,000	
	To Capital Redemption Reserve A/c (Note 2)				1,00,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)				

Working Notes :

(1) ***Alternatively***, the following entries can be passed :

		₹	₹
(i) Equity Share Capital Account	Dr.	6,00,000	
Premium on Buy Back Account	Dr.	1,50,000	
To Equity Shareholders Account			7,50,000
(ii) Securities Premium Account	Dr.	1,00,000	
General Reserve Account	Dr.	50,000	
To Premium on Buy Back Account			1,50,000

(2) Calculation of Amount to be Transferred to Capital Redemption Reserve Account

	₹
Face value of equity shares brought back	6,00,000
Less: Proceeds from issue of 7.5% preference shares	5,00,000
	1,00,000

Tutorial Note : Amount to be transferred to Capital Redemption Reserve Account = ₹ 1,00,000 (after adjusting the proceeds from the issue of 7.5% Preference Shares).

As per the provision of Section 69 of the Companies Act, 2013, Capital Redemption Reserve is to be created out of free reserves or securities premium.

Balance left in General Reserve (₹ 80,000 – 50,000) = ₹ 30,000.

Balance ₹ 70,000 is to be transferred from Profit and Loss balance.

(3) Sources Utilised for CRR

	₹
(i) General Reserve (80,000 – 50,000)	30,000
(ii) Profit and Loss Account (1,00,000 – 30,000)	70,000
	1,00,000

Illustration 3

The Balance Sheet of Black Ltd. as on 31st March, 2017 is as follows :

Balance Sheet of Black Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	80,00,000
(b) Reserves and Surplus	(2)	36,80,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6.5% Debentures		3,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		2,53,000
TOTAL		1,22,33,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	85,00,000
(b) Non-current Investments		
(2) Current Assets :		
(a) Current Investments		10,80,000
(b) Inventories		—
(c) Trade Receivables		5,40,000
(d) Cash and Cash Equivalents		21,13,000
TOTAL		1,22,33,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,00,000 Equity Shares of ₹ 10 each	1,00,00,000
Issued, Subscribed and Paid-up Capital :	
8,00,000 Equity Shares of ₹ 10 each fully paid-up	80,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	25,00,000
General Reserve	7,00,000
Profit and Loss	4,80,000
	36,80,000

(3) Fixed Assets :

(a) *Tangible*	
Land and Building	30,00,000
Machinery	45,00,000
Furniture	10,00,000
	85,00,000

On 1st April, 2017 the company announced the buy back of its 25% equity shares at ₹ 20 per share. For that purpose the company sold its entire investments at ₹ 12,00,000 and issued 8,000, 10% Preference Shares of ₹ 100 each. The company utilised 50% of the General Reserve, 100% of the Profit and Loss Account and the rest was taken from the Securities Premium Account. Show necessary Journal Entries.

Solution

In the books of Black Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2017	Bank A/c	Dr.		12,00,000	
April 1	To Investments A/c				10,80,000
	To Profit and Loss A/c				1,20,000
	(Being the sale of investment at a profit which has been transferred to Profit and Loss Account)				
	Bank A/c	Dr.		8,00,000	
	To 10% Preference Share Application A/c				8,00,000
	(Being the application money received on 8,000, 10% preference shares @ ₹ 100 each)				
	10% Preference Share Application A/c	Dr.		8,00,000	
	To 10% Preference Share Capital A/c				8,00,000
	(Being preference share application money transferred to Preference Share Capital Account as per Special Resolution No. . . . dated . . .)				
	Equity Share Capital A/c	Dr.		20,00,000	
	Securities Premium A/c	Dr.		20,00,000	
	To Equity Shareholders A/c				40,00,000
	(Being the amount payable to equity shareholders on buy back of 2 lakhs equity shares of ₹ 10 each at a premium of ₹ 10 per share as per Special Resolution No. . . . dated . . .)				
	Equity Shareholders A/c	Dr.		40,00,000	
	To Bank A/c				40,00,000
	(Being equity shareholders paid-off against buy back of shares)				
	General Reserve A/c (Note 2)	Dr.		3,50,000	
	Profit and Loss A/c	Dr.		6,00,000	
	Securities Premium A/c	Dr.		2,50,000	
	To Capital Redemption Reserve A/c (Note 1)				12,00,000
	(Being the amount transferred to Capital Redmeption Reserve Account as per the requirement of the Act)				

Working Notes :

(1) Amount to be Transferred to Capital Redemption Reserve Account

	₹
Face value of equity shares brought back	20,00,000
Less: Proceeds from issue of 8,000, 10% preference shares of ₹ 100 each	8,00,000
	12,00,000

(2) Sources Utilised for CRR

(i) 50% of General Reserve (50% of ₹ 7,00,000)	3,50,000
(ii) 100% of Profit and Loss Account (₹ 4,80,000 + ₹ 1,20,000)	6,00,000
(iii) Securities Premium (Balancing figure)	2,50,000
	12,00,000

Illustration 4

On 31st March, 2017 following was the Balance Sheet of New Era Ltd. :

Balance Sheet of New Era Ltd. as at 31st March, 2017

Particulars (1)	Note No. (2)	Amount (₹ in Lakhs) (3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,400
(b) Reserves and Surplus	(2)	1,620
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		1,500
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		750
(c) Other Current Liabilities		390
TOTAL		6,660
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	4,052
(b) Non-current Investments		
(2) Current Assets :		
(a) Current Investments		148
(b) Inventories		1,200
(c) Trade Receivables		520
(d) Cash and Cash Equivalents		740
TOTAL		6,660

Notes to Accounts :

(1) Share Capital

Particulars	₹ in Lakhs
Authorised Capital :	
300 Lakhs Equity Shares of ₹ 10 each	3,000
3 Lakhs Preference Shares of ₹ 100 each	300
	3,300
Issued, Subscribed and Paid-up Capital :	
240 Lakhs Equity Shares of ₹ 10 each fully paid	2,400

(2) Reserve and Surplus

Particulars	₹ in Lakhs
Securities Premium	350
General Reserve	930
Profit and Loss Account	340
	1,620

(3) Fixed Assets :

(a) *Tangible Assets*	
Plant and Machinery	3,600
Furniture	452
	4,052

On 1st April, 2017, the company announced the buy back of 25% of its equity shares @ ₹ 15 per share. For this purpose, it sold all of its investments for ₹ 150 lakhs and issued 2,00,000, 14% preference shares of ₹ 100 each at par — the entire amount being payable with application.

The issue was fully subscribed. The company achieved the target of the buy back. Later the company issued one fully paid-up equity share of ₹ 10 by way of bonus shares for every four equity shares held by the equity shareholders.

Show journal entries for all the transactions including cash transactions.

Solution

In the books of New Era Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹ (Lakhs)	Cr. ₹ (Lakhs)
2017	Bank A/c	Dr.		150	
April 1	To Investments A/c				148
	To Profit and Loss A/c				2
	(Being the investments sold at a profit)				
	Bank A/c	Dr.		200	
	To 14% Preference Share Application A/c				200
	(Being the application money received on 2,00,000, 14% preference shares @ ₹ 100 each)				
	14% Preference Share Application A/c	Dr.		200	
	To 14% Preference Share Capital A/c				200
	(Being preference share application money transferred to Preference Share Capital Account as per Resolution No. . . . dated . . .)				
	Equity Share Capital A/c	Dr.		600	
	Securities Premium A/c	Dr.		300	
	To Equity Shareholders A/c				900
	(Being the amount payable to equity shareholders on buy back of 60 lakhs equity shares as per Special Resolution No. . . . dated . . .)				

Equity Shareholders A/c Dr. To Bank A/c (Being equity shareholders paid-off against buy back of shares)		900	900
General Reserve A/c (Note 1) Dr. To Capital Redemption Reserve A/c (Being the creation of capital redemption reserve as per requirement of the Act)		400	400
Capital Redemption Reserve A/c Dr. Securities Premium A/c Dr. To Bonus to Shareholders A/c (Note 2) — See Tutorial Note (Being the bonus dividend declared in the ratio of 1 : 4 as per Shareholders' Resolution No. . . . dated . . .)		400 50	450
Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Being the bonus dividend utilised towards the issue of equity shares as per Board's Resolution No. . . . dated . . .)		450	450

Working Notes :

(1) Calculation of Amount to be Transferred to Capital Redemption Reserve

	₹ in Lakhs
Face value of equity shares bought back	600
Less: Proceeds from issue of 14% preference shares	200
	400

(2) Calculation of Number of Bonus Shares

Number of equity shares after buy back = 180 lakhs.

Bonus issued in the ratio of one share for four shares held. Therefore,

Number of bonus shares $= \frac{180}{4} \times 1 = 45$ lakhs equity shares

$\therefore$ Amount of bonus = 45 lakhs × ₹ 10 = **₹ 450 lakhs.**

Tutorial Note : As per the provision of Section 68(8) of the Companies Act, 2013, after the completion of buy back of shares, the company cannot issue any shares within a period of ***6 months*** except bonus shares.

Illustration 5

The Balance Sheet of Modern Marbles Ltd. as at 31st March, 2017 is as follows:

Balance Sheet of Modern Marbles Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	50,00,000
(b) Reserves and Surplus	(2)	15,65,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	38,25,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		8,67,000
TOTAL		1,12,57,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		66,00,000
(b) Non-current Investments		18,00,000

(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		11,87,000
(c) Trade Receivables		9,60,000
(d) Cash and Cash Equivalents		7,10,000
TOTAL		1,12,57,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
5,00,000 Equity Shares of ₹ 10 each	50,00,000
Issued, Subscribed and Paid-up Capital :	
5,00,000 Equity Shares of ₹ 10 each fully paid	50,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	6,50,000
Securities Premium	5,40,000
Profit and Loss	3,75,000
	15,65,000

(3) Long-term Borrowings

Particulars	₹
12% Debentures	25,00,000
Term Loan	13,25,000
	38,25,000

The shareholders adopted the resolution on the date of the above mentioned Balance Sheet to :

(i) buy back 20% of the paid-up capital @ ₹ 15 each.

(ii) issue 5,000, 13% Debentures of ₹ 100 each at a premium of 10% to finance the buy back of shares.

(iii) maintain a balance of ₹ 3,00,000 in general reserve account; and

(iv) sell investments worth ₹ 8,00,000 for ₹ 6,50,000.

You are required to pass the necessary journal entries to record the above transactions and prepare the Balance Sheet immediately after the buy back. *[C.S. (Inter) — Adapted]*

Solution

In the books of Modern Marbles Limited

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		5,50,000	
	To 13% Debentures Application A/c				5,50,000
	(Being application money recd. for 5,000 debentures of ₹ 100 each at a premium of 10%)				
	13% Debentures Application A/c	Dr.		5,50,000	
	To 13% Debentures A/c				5,00,000
	To Debenture Premium A/c*				50,000
	(Being the debentures application money transferred to 13% Debentures Account and Debenture Premium Account as per Board's Special Resolution No. . . . dated . . .)				
	Bank A/c	Dr.		6,50,000	
	Profit and Loss A/c	Dr.		1,50,000	
	To Investments A/c				8,00,000
	(Being the investments sold at a loss)				
	Equity Share Capital A/c	Dr.		10,00,000	
	Securities Premium A/c	Dr.		5,00,000	
	To Equity Shareholders A/c				15,00,000
	(Being the amount payable to equity shareholders on buy back of 1,00,000 equity shares as per Special Resolution No. . . . dated . . .)				
	Equity Shareholders A/c	Dr.		15,00,000	
	To Bank A/c				15,00,000
	(Being equity shareholders paid-off against buy back of shares)				
	General Reserve A/c (₹ 6,50,000 – 3,00,000)	Dr.		3,50,000	
	Profit and Loss A/c (₹ 5,00,000 – 3,50,000)	Dr.		1,50,000	
	To Capital Redemption Reserve A/c (Note 1)				5,00,000
	(Being the creation of capital redemption reserve as per requirement of the Act)				

*It should be noted that debenture premium is not a part of the Securities Premium Account.

Modern Marbles Limited
Balance Sheet as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	40,00,000
(b) Reserves and Surplus	(2)	9,65,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	43,25,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		8,67,000
(d) Short-term Provisions		—
TOTAL		1,01,57,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		66,00,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		10,00,000
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		11,87,000
(c) Trade Receivables		9,60,000
(d) Cash and Cash Equivalents		4,10,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		1,01,57,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Share Capital :		
5,00,000 Equity Shares of ₹ 10 each		50,00,000
Issued and Subscribed Capital :		
4,00,000 Equity Shares of ₹ 10 each fully paid		40,00,000
(3) Long-term Borrowings		
(a) *Secured Loans* :		
12% Debentures	25,00,000	
13% Debentures	5,00,000	
Term Loan	13,25,000	43,25,000
		43,25,000

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve (Note 1)	5,00,000
Securities Premium	40,000
Debentures Premium	50,000
General Reserve	3,00,000
Profit and Loss Account (Note 2)	75,000
	9,65,000

Working Notes :

(1) Calculation of Amount to be Transferred to Capital Redemption Reserve

	₹
Face value of equity shares bought back	10,00,000
Less: Proceeds from issue of 13% Debentures	5,00,000
	5,00,000

(2) Balance of Profit and Loss Account

	₹
Balance as per Balance Sheet	3,75,000
Less: Loss on Sale of Investment	1,50,000
	2,25,000
Less: Transferred to Capital Redemption Reserve	1,50,000
	75,000

Illustration 6

Dee Limited furnished the following summarised Balance Sheet as at 31st March, 2017 :

Balance Sheet of Dee Limited as at 31st March, 2017

Particulars	Note No.	Amount (₹ '000)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	27,00
(b) Reserves and Surplus	(2)	97,00
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		14,00
TOTAL		1,38,00
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		93,00
(b) Non-current Investments		—
(2) Current Assets :		
(a) Current Investments		30,00
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		15,00
TOTAL		1,38,00

Notes to Accounts :

(1) Share Capital

Particulars	(₹ '000)
Authorised Share Capital :	
2,50,000 Equity Shares of ₹ 10 each	25,00
5,000 Preference Shares of ₹ 100 each	5,00
	30,00
Issued and Subscribed Capital :	
2,50,000 Equity Shares of ₹ 10 each fully paid	25,00
2,000, 10% Preference Sh. of ₹ 100 each fully paid (Issued for the purpose of buy back)	2,00
	27,00

(2) Reserve and Surplus

Particulars	(₹ '000)
Capital Reserve	10,00
General Reserve	30,00
Securities Premium	22,00
Profit and Loss Account	35,00
	97,00

The company passed a resolution to buy back 20% of its equity capital @ ₹ 50 per share. For this purpose, it sold all of its investment for ₹ 22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet after buy-back.

Solution

In the books of Dee Limited
Journal

Date	Particulars		L.F.	Dr. ₹ ('000)	Cr. ₹ ('000)
	Bank A/c	Dr.		22,00	
	Profit and Loss A/c (Loss on Sale of investment)	Dr.		8,00	
	To Investments A/c				30,00
	(Being the sale of investments at a loss for the purpose of buy-back of shares)				
	Equity Shares Capital A/c	Dr.		5,00	
	Securities Premium A/c	Dr.		20,00	
	To Equity Shareholders A/c				25,00
	(Being the amount payable to equity shareholders on buy-back of 50,000 equity shares as per Special Resolution No. ... dated ...)				
	Equity Shareholders A/c	Dr.		25,00	
	To Bank A/c				25,00
	(Being equity shareholders paid-off against buy-back)				
	Securities Premium A/c (Note 1)	Dr.		2,00	
	General Reserve A/c (Note 1)	Dr.		1,00	
	To Capital Redemption Reserve A/c (Note 1)				3,00
	(Being the necessary amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)				

Working Notes :

(1) Amount to be transferred to Capital Redemption Reserve Account	₹
Nominal value of shares brought back	5,00,000
Less: Proceeds from fresh issue for buy back	2,00,000
Transferred to CRR	3,00,000
(i) Securities Premium has been used (22,00,000 – 20,00,000)	2,00,000
(ii) General Reserve has been used (3,00,000 – 2,00,000)	1,00,000
Total	3,00,000

Dee Ltd
Balance Sheet as at 1st April, 2017

Particulars (1)	Note No. (2)	(₹ '000) (3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	22,00
(b) Reserves and Surplus	(2)	69,00
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		14,00
(d) Short-term Provisions		—
TOTAL		1,05,00
II. ASSETS		
(1) Non-current Assets :		—
(a) Fixed Assets		93,00
(i) Tangible Assets		—
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—

(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents (₹ 15,00 + 22,00 – 25,00)		12,00
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		1,05,00

Notes to Accounts :

(1) Share Capital

Particulars	(₹ '000)
Authorised Share Capital :	
2,50,000 Equity Shares of ₹ 10 each	25,00
5,000 Preference Shares of ₹ 100 each	5,00
	30,00
Issued and Subscribed Capital :	
2,00,000 Equity Shares of ₹ 10 each fully paid	20,00
2,000, 10% Preference Sh. of ₹ 100 each fully paid	2,00
	22,00

(2) Reserve and Surplus

Particulars	(₹ '000)
Capital Reserve	10,00
Capital Redemption Reserve	3,00
General Reserve	29,00
Profit and Loss Account (₹ 35,00 – 8,00)	27,00
	69,00

Illustration 7

The following is the Balance Sheet of ABC Limited as on 31.3.2017 :

Balance Sheet of ABC Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus	(2)	15,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	23,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		15,00,000
TOTAL		63,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		15,00,000
(b) Non-current Investments		3,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		10,00,000
(c) Trade Receivables		10,00,000
(d) Cash and Cash Equivalents		25,00,000
TOTAL		63,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid-up	10,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	12,00,000
Profit and Loss Account	1,00,000
Securities Premium	2,00,000
	15,00,000

(3) Long-term Borrowings

Particulars	₹
Secured Loans	15,00,000
Unsecured Loans	8,00,000
	23,00,000

The company intends to buy back 20,000 equity shares of ₹ 10 each at a premium of 150%.

State whether the company can do so and if yes, then pass journal entries. Also prepare the post-buy back Balance Sheet.

Solution

Working Notes :

(1) The company wants to buy back equity shares as under :

	₹
Nominal value — 20,000 × ₹ 10	2,00,000
Add: Premium on buy back (150% of ₹ 2,00,000)	3,00,000
Amount of buy back	5,00,000

(2) The buy back should not exceed 25% of the total paid-up capital and ***free reserves***, which is calculated as under :

	₹
Equity Share Capital	10,00,000
General Reserve	12,00,000
Profit and Loss Account	1,00,000
Securities Premium (Note 5)	2,00,000
	25,00,000

Maximum amount of buy back is 25% of ₹ 25,00,000 = ₹ 6,25,000. Therefore, the company can meet this criterion.

(3) The buy back of equity shares in any financial year shall not exceed 25% of its paid-up capital in that financial year. Therefore, the face value of equity shares that can be bought back is 25% of ₹ 10,00,000 = ₹ 2,50,000. This is within the limit.

(4) The post-buy back debt-equity ratio should not exceed 2 : 1. Here, the debt is ₹ 23,00,000 and equity will be ₹ 20,00,000 (₹ 25,00,000 – 5,00,000). Therefore, the ratio is 1.15 : 1 and within the limit.

Tutorial Note : As per the provision of ***Section 68(2)(d),*** Debt = Aggregate of Secured and Unsecured Debts owed by the company.

(5) Explanation II of Section 68 of the Companies Act, 2013 states that free reserves includes ***securities premium.***

ABC Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Equity Share Capital A/c	Dr.		2,00,000	
	Securities Premium A/c	Dr.		2,00,000	
	General Reserve A/c	Dr.		1,00,000	
	To Equity Shareholders A/c				5,00,000
	(Being the amount payable to equity shareholders on buy back of 20,000 equity shares as per Special Resolution No. . . . dated . . .)				
	Equity Shareholders A/c	Dr.		5,00,000	
	To Bank A/c				5,00,000
	(Being the equity shareholders paid-off against buy back of shares)				
	General Reserve A/c	Dr.		2,00,000	
	To Capital Redemption Reserve A/c				2,00,000
	(Being the creation of capital redemption reserve as per requirement of the Act)				

ABC Ltd
Balance Sheet as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus	(2)	12,00,000
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	23,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		15,00,000
(d) Short-term Provisions		—
TOTAL		58,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		15,00,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		3,00,000
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		10,00,000
(c) Trade Receivables		10,00,000
(d) Cash and Cash Equivalents		20,00,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		58,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
Issued and Subscribed Capital :	
80,000 Equity Shares of ₹ 10 each fully paid	8,00,000

(3) Long-term Borrowings

Particulars	₹
Secured Loans	15,00,000
Unsecured Loans	8,00,000
	23,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve	2,00,000
General Reserve	9,00,000
Profit and Loss Account	1,00,000
	12,00,000

Illustration 8

Following is the Balance Sheet of M/s Competent Limited as on 31st March, 2017 :

Balance Sheet of M/s Competent Limited as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,50,000
(b) Reserves and Surplus	(2)	18,75,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	28,75,000

(4) Current Liabilities :		
(a) Short-term Borrowings		6,50,000
(b) Trade Payables		5,00,000
(c) Other Current Liabilities		5,00,000
TOTAL		76,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	46,50,000
(b) Non-current Investments		
(2) Current Assets :		
(a) Current Investments		5,00,000
(b) Inventories		5,00,000
(c) Trade Receivables		5,00,000
(d) Cash and Cash Equivalents		15,00,000
TOTAL		76,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
Issued, Subscribed and Paid-up Capital :	
1,25,000 Equity Shares of ₹ 10 each fully paid	12,50,000

(2) Reserve and Surplus

Particulars	₹
Revenue Reserve	15,00,000
Securities Premium	2,50,000
Profit and Loss Account	1,25,000
	18,75,000

(3) Long-term Borrowings

Secured Loans :	
12% Debentures	18,75,000
Unsecured Loans	10,00,000
	28,75,000

(4) Fixed Assets

(a) *Tangible Assets*	
Land and Building	26,50,000
Plant and Machinery	15,00,000
Furniture and Fittings	5,00,000
	46,50,000

The company wants to buy back 25,000 equity shares of ₹ 10 each on 1st April, 2017 at ₹ 20 per share. Buy back of shares is duly authorised by its articles and necessary resolution passed by the company towards this. The payment for buy back of shares will be made by the company out of sufficient bank balance available.

Comment with your calculations, whether buy back of shares by company is within the provisions of the Companies Act, 2013. If yes, pass necessary journal entries towards buy back of shares and prepare a Balance Sheet after buy back of shares.

Solution

(1) The company wants to buy back equity shares as under :

	₹
Nominal value (25,000 × ₹ 10)	2,50,000
Add: Premium (25,000 × ₹ 10)	2,50,000
Amount of buy back	5,00,000

(2) The buy-back should not exceed 25% of the total paid-up capital and ***free reserves***, which is calculated as follows :

	₹
Equity share capital	12,50,000
Revenue reserve	15,00,000
Profit and Loss Account	1,25,000
Securities Premium	2,50,000
	31,25,000

Maximum amount of buy back is 25% of ₹ 31,25,000 = ₹ 7,81,250. Therefore, the company can meet this criterion.

(3) The buy-back of equity shares in any financial year shall not exceed 25% of its paid-up capital in that financial year. Therefore, the face value of equity shares that can be brought back is 25% of ₹ 12,50,000 = ₹ 3,12,500. This is within the limit.

(4) The post buy-back debt-equity ratio should not exceed 2 : 1. Here, the debt is ₹ 28,75,000 (18,75,000 + 10,00,000) and post buy back equity will be (31,25,000 – 5,00,000 = 26,25,000). Therefore, the debt equity ratio = 1.09 : 1 and within the limit. As per the provision of ***Section 68(2)(d),*** Debt = Aggregate of Secured and Unsecured Debts owned by the company.

In the books of M/s Competent Limited
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Equity Shares Capital A/c Dr.		2,50,000	
	Securities Premium A/c Dr.		2,50,000	
	To Equity Shareholders A/c			5,00,000
	(Being the amount payable to equity shareholders on buy-back of 25,000 equity shares of ₹ 10 each at a premium of ₹ 10 each as per special resolution No. ... dated ...)			
	Equity Shareholders A/c Dr.		5,00,000	
	To Bank A/c			5,00,000
	(Being the equity shareholders paid-off)			
	Revenue Reserve A/c Dr.		2,50,000	
	To Capital Redemption Reserve A/c			2,50,000
	(Being the transfer of free reserve to Capital Redemption Reserve Account as per the requirement of the Act)			

M/s Competent Limited
Balance Sheet as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus	(2)	16,25,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	28,75,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		6,50,000
(b) Trade Payables		5,00,000
(c) Other Current Liabilities		5,00,000
(d) Short-term Provisions		—
TOTAL		71,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	46,50,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		5,00,000
(b) Inventories		5,00,000
(c) Trade Receivables		5,00,000
(d) Cash and Cash Equivalents		10,00,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		71,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
Issued and Subscribed Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve	2,50,000
Revenue Reserve	12,50,000
Profit and Loss Account	1,25,000
	16,25,000

(3) Long-term Borrowings

(a) *Secured Loans* :	
12% Debentures	18,75,000
(b) *Unsecured Loans*	10,00,000
	28,75,000

(4) Fixed Assets

(a) *Tangible Assets*	
Land and Building	26,50,000
Plant and Machinery	15,00,000
Furniture	5,00,000
	46,50,000

Illustration 9

The following is the Balance Sheet of ABC Limited as on 31.3.2017 :

Balance Sheet of ABC Limited as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	80,00,000
(b) Reserves and Surplus	(2)	80,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	40,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		30,00,000
TOTAL		2,30,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	98,00,000
(b) Non-current Investments		15,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		20,00,000
(c) Trade Receivables		50,00,000
(d) Cash and Cash Equivalents		47,00,000
TOTAL		2,30,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,00,000 Equity Shares of ₹ 10 each	1,00,00,000
Issued, Subscribed and Paid-up Capital :	
8,00,000 Equity Shares of ₹ 10 each fully paid	80,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	10,00,000
Profit and Loss Account	50,00,000
Securities Premium	20,00,000
	80,00,000

(3) Long-term Borrowings

Secured Loans :	
12% Debentures	20,00,000
Unsecured Loans	20,00,000
	40,00,000

(4) Fixed Assets

(a) *Tangible Assets*	
Land and Building	40,00,000
Plant and Machinery	36,00,000
Furniture and Fittings	22,00,000
	98,00,000

The company decides to buy back the maximum number of equity shares as may be permitted by law at a price of ₹ 20 per share. You are required to pass journal entries and prepare post buy back Balance Sheet.

Solution

Working Notes :

(1) The buy back should not exceed 25% of the **total paid-up capital and free reserves**.

Total capital and free reserves are as under :

	₹
Equity Share Capital	80,00,000
General Reserve	10,00,000
Profit and Loss Account	50,00,000
Securities Premium	20,00,000
	1,60,00,000

Maximum amount of buy back is, therefore, 25% of ₹ 1,60,00,000 = ₹ **40,00,000**.

(2) The buy back of equity shares in any financial year shall not exceed 25% of its total paid-up equity capital in that financial year. Therefore, the face value of the equity shares that can be bought back is 25% of ₹ 80,00,000 = ₹ 20,00,000. As per law, Company can buy equity shares of ₹ 20,00,000 (being lower of ₹ 40,00,000 and ₹ 20,00,000). If the shares of ₹ 20,00,000 are bought back the debt-equity ratio will be 0. 29 : 1 which is more than the required debt-equity ratio of 2 : 1.

In the books of ABC Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Equity Share Capital A/c	Dr.		20,00,000	
	Securities Premium A/c	Dr.		20,00,000	
	To Equity Shareholders A/c				40,00,000
	(Being the amount payable to equity shareholders on buy back of 2,00,000 equity shares as per Special Resolution No. . . . dated . . .)				
	Equity Shareholders A/c	Dr.		40,00,000	
	To Bank A/c				40,00,000
	(Being the equity shareholders paid-off against buy back of shares)				
	Profit and Loss A/c	Dr.		20,00,000	
	To Capital Redemption Reserve A/c				20,00,000
	(Being the creation of capital redemption reserve as per requirement of the Act)				

ABC Limited
Balance Sheet as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	60,00,000
(b) Reserves and Surplus	(2)	60,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	40,00,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		20,00,000
(c) Other Current Liabilities		10,00,000
(d) Short-term Provisions		—
TOTAL		1,90,00,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	98,00,000
(b) Non-current Investments		15,00,000
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		20,00,000
(c) Trade Receivables		40,00,000
(d) Cash and Cash Equivalents		7,00,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		10,00,000
TOTAL		1,90,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
10,00,000 Equity Shares of ₹ 10 each	1,00,00,000
Issued and Subscribed Capital :	
6,00,000 Equity Shares of ₹ 10 each fully paid	60,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve	20,00,000
General Reserve	10,00,000
Profit and Loss Account	30,00,000
	60,00,000

(3) Long-term Borrowings

Secured Loans : 10% Debentures	20,00,000
Unsecured Loans	20,00,000
	40,00,000

(4) Fixed Assets

Land and Buildings	40,00,000
Plant and Machinery	36,00,000
Furniture and Fixtures	22,00,000
	98,00,000

Illustration 10

The following is the Balance Sheet of ABC Limited as at 31.3.2017 :

Balance Sheet of ABC Limited as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,10,000
(b) Reserves and Surplus	(2)	1,80,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	3,70,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		10,000
TOTAL		6,70,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,00,000
(b) Non-current Investments		1,20,000

(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		2,50,000
TOTAL		6,70,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
10,000 Equity Shares of ₹ 10 each		1,00,000
2,000 Preference Shares of ₹ 10 each		20,000
		1,20,000
Issued, Subscribed and Paid-up Capital :		
10,000 Equity Shares of ₹ 10 each fully paid		1,00,000
1,000 Preference Shares of ₹ 10 each		10,000
		1,10,000
(3) Long-term Borrowings		
10% Debentures	80,000	
Term Loan (Secured)	30,000	1,10,000
Term Loan (Unsecured)		2,60,000
		3,70,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	10,000
General Reserve	70,000
Profit and Loss account	20,000
Debenture Redemption Reserve	40,000
Investment Allowance Reserve (Available for utilisation — ₹ 20,000)	36,000
Capital Redemption Reserve	4,000
	1,80,000

Additional information :

(i) Investments of the cost of ₹ 40,000 were sold for ₹ 30,000.

(ii) Additional tax liability for income tax ₹ 2,000 for the year 2013-14.

(iii) The company intends to buy back its equity shares at the beginning of the next financial year to the maximum extent as permissible under law.

You are required to compute the maximum number of equity shares that can be bought back by the company. Also pass necessary journal entries assuming that such buy back has been carried out and prepare the new Balance Sheet.

Solution

We impress that according to Section 68(2), the Debt-Equity ratio, as after the buy back of the shares shall not be more than 2. 'Equity' means paid-up share capital (Equity Share Capital and Preference Share Capital) and the ***balance*** of ***free reserves*** after the buy back of shares. Free reserves are to be calculated after writing off any loss, fictitious asset or goodwill. Such adjustments are quite rational; but the free reserves would mean the profit available for distribution as dividend as per Section 123 after providing for depreciation as per Schedule II to the Companies Act, 2013 and the balance of securities premium, if any. [***Explanation II of Section 68 of the Companies Act, 2013]***

This ***Illustration*** has been worked out on that line.

The 'Debts' signify total external debts including the ***creditors and current liabilities***. Such is the view expressed in —

1. The Study Materials of the Institute of Company Secretaries on Company Accounts, with reference to Section 68(2) clause (d).
2. Also according to the "Manuals of Companies Act and Corporate Laws" by R. Puliani and M. Puliani (Bharat Publisher, 2005), Page 1.85. Debts include all secured and unsecured debts including creditors and current liabilities.

It appear controversial to deduct the Debenture Redemption Reserve (DRR) from the Debentures, because creation of such reserve does not reduce the liabilities and that is why it is wise to take debentures ***in full amount without adjusting the Debenture Redemption Reserve***.

The Debenture Redemption Reserve is to be created as per Rule 18(7) of the Companies (Share Capital and Debentures) Rules, 2014. Only on redemption of all such Debentures the DRR is transferred to General Reserve. So it appears that the DRR is not a free reserve and it has no significance to reduce the debenture liabilities by adjusting the amount with debentures. Therefore, the Debentures has been taken in full value without adjusting DRR.

Based on the above concept, we calculate ***Debts*** as :

	₹
10% Debentures	80,000
Term Loan (secured)	30,000
Unsecured Loan (Long term)	2,60,000
Current Liabilities (₹ 10,000 + ₹ 2,000 for unpaid tax)	12,000
	3,82,000

50% of Debts $= \frac{1}{2} \times 3,82,000 =$ ₹ **1,91,000**.

Therefore, "Equity" (Capital + Free Reserves) shall be at least ₹ **1,91,000 as after the buy back.**

			₹
Equity :	Equity Share Capital (₹ 1,00,000 – 25,000)		75,000
	Preference Share Capital		10,000
	Securities Premium		10,000
	General Reserve		70,000
	Profit and Loss Account		20,000
	Investment Allowance Reserve		20,000
			2,05,000
Less:	Loss on Sale of Investments	10,000	
	Provision for tax	2,000	12,000
			1,93,000
∴ Maximum Premium (₹ 1,93,000 – ₹ 1,91,000)			2,000
	Balance Equity		1,91,000

∴ Total Payment to Shareholders = ₹ 25,000 + ₹ 2,000 = ₹ 27,000 and this is not exceeding 25% of (Capital + Free Reserve). Thus 25% of (₹ 1,10,000 + ₹ 1,08,000) = ₹ 54,500) as has been calculated as follows :

		₹
Total paid-up capital		
Equity Share Capital		1,00,000
Preference Share Capital		10,000
		1,10,000
Free Reserves		
Securities Premium		10,000
General Reserve		70,000
Profit and Loss Account		20,000
Investment Allowance Reserve		20,000
		1,20,000
Less: Loss on Sale of Investments	10,000	
Additional Tax Liability	2,000	12,000
		1,08,000

In the books of ABC Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		30,000	
	Statement of Profit and Loss	Dr.		10,000	
	To Investments A/c				40,000
	(Being the investments sold at a loss)				
	Equity Share Capital A/c	Dr.		25,000	
	Securities Premium A/c	Dr.		2,000	
	To Equity Shareholders A/c				27,000
	(Being the amount payable to equity shareholders on buy back of 2,500 equity shares as per Board's Resolution No. . . . dated . . .)				
	Equity Shareholders A/c	Dr.		27,000	
	To Bank A/c				27,000
	(Being the equity shareholders paid-off against buy back of shares)				
	Statement of Profit and Loss	Dr.		2,000	
	To Liability for Tax A/c				2,000
	(Being liability for tax created)				
	General Reserve A/c	Dr.		25,000	
	To Capital Redemption Reserve A/c				25,000
	(Being the creation of capital Redemption Reserve Account as per requirement of the Act)				

ABC Ltd
Balance Sheet as at 31st March, 2017

Particulars	Note No.	Figures as at the end of current reporting period (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	85,000
(b) Reserves and Surplus	(2)	1,66,000
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	3,70,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		12,000
(d) Short-term Provisions		—
TOTAL		6,33,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,00,000
(b) Non-current Investments		80,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents (₹ 2,50,000 + 30,000 – 27,000)		2,53,000
TOTAL		6,33,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Share Capital :		
10,000 Equity Shares of ₹ 10 each		1,00,000
2,000 Preference Shares of ₹ 10 each		20,000
		1,20,000
Issued, Subscribed and Paid-up Capital :		
7,500 Equity Shares of ₹ 10 each		75,000
1,000 Preference Shares of ₹ 10 each		10,000
		85,000

(3) Long-term Borrowings

(a) Secured Loans		
(i) 10% Debentures	80,000	
(ii) Term Loans	30,000	1,10,000
(b) Unsecured Loans		2,60,000
		3,70,000

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve (₹ 4,000 + 25,000)	29,000
Debenture Redemption Reserve	40,000
Investment Allowance Reserve	36,000
Securities Premium	8,000
Profit and Loss Balance (₹ 20,000 – 10,000 – 2,000)	8,000
General Reserve (₹ 70,000 – ₹ 25,000)	45,000
	1,66,000

(4) Other Current Liabilities

Current Liabilities and Provisions	10,000
Tax Liability	2,000
	12,000

KEY POINTS

- Buy-back is a process by which a cash-rich company purchases and cancells some of its outstanding equity shares.
- Buy back is a useful tool to enhance shareholders' value. After buy back, there is a reduction in the number of shares and therefore, EPS will go up.
- Company may buy-back its own shares out of :
  (i) Free reserves
  (ii) Securities Premium
  (iii) the proceeds of the issue of any share or other securities but it cannot buy-back equity shares by issuing equity shares.
- The buy back should be authorised by its articles.
- A special resolution has to be passed at a general meeting of the company authorising the buy back.
- A company shall not make any offer of buy back within a period of ***one year*** reckoned from the date of closure of the preceding offer of buy back, if any.

THEORETICAL QUESTIONS

1. (a) What do you mean by "buy back of shares"? (b) What are the objectives of buying back ?
2. How do you calculate the size of the buy back ?
3. State the sources of buy back in detail.
4. State the meaning of the following in relation to buy back of shares :
   (a) Free reserves; and (b) Proceeds of an earlier issue.
5. State the conditions and limits of buy back.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. The buy back of equity shares in any financial year should not exceed
   A 20% of the total paid-up equity share capital in that financial year
   B 25% of the total paid-up equity share capital in that financial year
   C 25% of the total called-up equity share capital in that financial year
   D 20% of the total paid-up equity share capital plus free reserves of that financial year
2. The special resolution will not be required when the buy back is not exceeding
   A 20% of total equity share capital plus free reserve of the company
   B 15% of total equity share capital plus free reserve of the company
   C 10% of total equity share capital plus free reserve of the company
   D none of the above
3. Post buy back debt-equity ratio should not exceed
   A 1 : 1
   B 1 : 2
   C 2 : 1
   D 3 : 2
4. Every buy back shall be completed within a period of
   A 6 months from the date of passing of the special resolution
   B 3 months from the date of passing of the special resolution
   C 1 year from the date of passing of the special resolution
   D 1 month from the date of passing of the special resolution
5. Shares bought back shall be extinguished and physically destroyed within
   A 10 days from the last date of completion of buy back
   B 5 days from the last date of completion of buy back
   C 15 days from the last date of completion of buy back
   D 7 days from the last date of completion of buy back
6. The offer for buy back shall remain open for a period of
   A not less than 10 days and not exceeding 20 days from the date of despatch of the letter of offer
   B not less than 15 days and not exceeding 20 days from the date of despatch of the letter of offer
   C not less than 15 days and not exceeding 30 days from the date of despatch of the letter of offer
   D not less than 20 days and not exceeding 30 days from the date of despatch of the letter of offer
7. SEBI (Buy back of Securities) Regulation, 1998 is applicable to
   A private limited companies only
   B unlisted public limited companies only
   C both private limited and public limited companies
   D only listed public limited companies
8. Rule 17 of the Companies (Share Capital and Debentures) Rules, 2014 is applicable to
   A only private limited companies
   B only unlisted public limited companies
   C only listed companies
   D all companies

9. Where a company purchases its own shares out of free reserve or securities premium, a sum should be transferred to Capital Redemption Reserve which should be
   A equal to the amount paid to the shareholder who sold his shares
   B equal to paid-up capital of the company
   C equal to the nominal value of shares so purchased
   D none of the above
10. A company after the completion of a buy back of its shares
   A can not issue same kind of shares within one year
   B can not issue same kind of shares within 6 months
   C can issue same kind of shares within 6 months
   D can not issue bonus shares

PRACTICAL QUESTIONS

1. The following is the Balance Sheet of XYZ Limited as on 31.3.2017 :

Balance Sheet of XYZ Limited as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	16,00,000
(b) Reserves and Surplus — Profit and Loss Account		1,20,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	2,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		80,000
(b) Trade Payables		2,00,000
TOTAL		22,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	16,00,000
(b) Non-current Investments		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		2,00,000
(d) Cash and Cash Equivalents		4,00,000
TOTAL		22,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
1,40,000 Equity Shares of ₹ 10 each	14,00,000
6,000 Preference Shares of ₹ 100 each	6,00,000
	20,00,000
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000
6,000 Preference Shares of ₹ 100 each	6,00,000
	16,00,000

(2) Long-term Borrowings

Particulars	₹
10% Secured Debentures	1,00,000
Long-term Loan	1,00,000
	2,00,000

(3) Fixed Assets

(a) *Tangible Assets :*	
Land and Building	4,00,000
Plant and Machinery	6,00,000
Furniture and Fixture	2,00,000
Motor Vehicles	4,00,000
	16,00,000

The company decides to buy back 20% of its paid-up equity share capital at ₹ 11 each. For that purpose, it decides to issue 1,600 preference shares of ₹ 100 each at ₹ 110.
You are required to pass journal entries to record the above transactions.

2. A limited company decides to buy back 50,000 equity shares of ₹ 10 each at a premium of 20%. For this purpose, it decides to issue 10% preference shares of ₹ 10 each at par. To meet the requirement of the law, the company has sufficient free reserves, i.e., General Reserves and Securities Premium Account.
You are required to pass journal entries to record the above transactions.

3. A company furnishes you with the following Balance Sheet as on 31.3.2017 :

Balance Sheet of BPL Ltd. as at 31st March, 2017

Particulars	Note No.	(₹ in Crore)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	150
(b) Reserves and Surplus	(2)	570
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Secured Debentures		80
(4) Current Liabilities :		
(a) Short-term Borrowings		10
(b) Trade Payables		50
(c) Other Current Liabilities		30
TOTAL		890
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	250
(b) Non-current Investments		
(2) Current Assets :		
(a) Current Investments		130
(b) Inventories		100
(c) Trade Receivables		150
(d) Cash and Cash Equivalents		260
TOTAL		890

Notes to Accounts :

(1) Share Capital

Particulars	₹ (Crore)
Authorised Share Capital :	
20,00,000 Equity Shares of ₹ 10 each	200
Issued, Subscribed and Paid-up Capital :	
15,00,000 Equity Shares of ₹ 10 each fully paid	150
Reserve and Surplus	
General Reserve	520
Securities Premium	50
	570

(3) Fixed Assets

Particulars	₹ (Crore)
(a) *Tangible Assets :*	
Plant and Machinery	100
Land and Building	100
Furniture	50
	250

The company intends to buy back 20% of its paid-up share capital. You are required to pass journal entries ensuring that it can meet the requirements of the Act.

4. The following is the Balance Sheet of ABC Limited as on 31.3.2017 :

Balance Sheet of ABC Ltd. as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	50,00,000
(b) Reserves and Surplus	(2)	17,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		4,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		2,00,000
(b) Trade Payables		3,00,000
(c) Other Current Liabilities		5,00,000
TOTAL		81,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	50,00,000
(b) Non-current Investments		5,00,000
(2) Current Assets :		
(a) Current Investments		2,00,000
(b) Inventories		8,00,000
(c) Trade Receivables		6,00,000
(d) Cash and Cash Equivalents		5,00,000
(e) Short-term Loans and Advances		3,00,000
(f) Other Current Assets		2,00,000
TOTAL		81,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
6,00,000 Equity Shares of ₹ 10 each	60,00,000
Issued, Subscribed and Paid-up Capital :	
5,00,000 Equity Shares of ₹ 10 each fully paid	50,00,000
Reserve and Surplus	
General Reserve	15,00,000
Profit and Loss Account	1,00,000
Securities Premium	1,00,000
	17,00,000

(3) Fixed Assets

Particulars	₹
(a) *Tangible Assets :*	
Land and Building	25,00,00
Plant and Machinery	20,00,000
Furniture and Fittings	5,00,000
	50,00,000

The Company decided to buy back 1,00,000 equity shares of ₹ 10 each at 25% premium. For this purpose, the company — (a) sold the entire investments at ₹ 6,00,000; (b) made a fresh issue of 10% preference shares of ₹ 100 each after utilising the securities premium account and half of general reserve.

You are required to pass journal entries.

5. The following is the Balance Sheet of ABC Limited as on 31.3.2017 :

Balance Sheet of ABC Limited as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus	(2)	7,00,000
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		10,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		2,00,000
(b) Trade Payables		3,00,000
(c) Other Current Liabilities		2,00,000
(d) Short-term Provisions		1,00,000
TOTAL		33,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	16,00,000
(b) Non-current Investments		5,00,000
(c) Other Non-current Assets		2,00,000
(2) Current Assets :		
(a) Current Investments		2,00,000
(b) Inventories		3,00,000
(c) Trade Receivables		3,00,000
(d) Cash and Cash Equivalents		2,00,000
TOTAL		33,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
75,000 Equity Shares of ₹ 10 each	7,50,000
2,500, 10% Preference Shares of ₹ 100 each	2,50,000
	10,00,000
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
2,000, 10% Preference Shares of ₹ 100 each	2,00,000
	8,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	300,000
Profit and Loss Account	1,00,000
Securities Premium	3,00,000
	7,00,000

(3) Fixed Assets

(a) *Tangible Assets :*	
Land and Building	6,00,000
Plant and Machinery	4,00,000
Furniture and Fittings	4,00,000
Motor Car	2,00,000
	16,00,000

The company intends to buy back its equity shares to the extent permitted by law. For this purpose, it wants to sell its investments at par. You are required to prepare post buy back Balance Sheet. Show your calculations.

6. The Balance Sheet of Sunny Electricals Ltd. as on 31st March, 2017 stood as under :

Balance Sheet of Sunny Electricals Ltd. as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,00,000
(b) Reserves and Surplus	(2)	62,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 9% Debentures		75,00,000
(b) Other Long-term Liabilities		80,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		9,00,000
(b) Trade Payables		10,00,000
(c) Other Current Liabilities		10,00,000
(d) Short-term Provisions — Income tax		6,00,000
TOTAL		4,52,00,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	2,73,60,000
(b) Non-current Investments		75,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		47,80,000
(c) Trade Receivables		40,20,000
(d) Cash and Cash Equivalents		15,40,000
TOTAL		4,52,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
25,00,000 Equity Shares of ₹ 10 each	2,50,00,000
Issued, Subscribed and Paid-up Capital :	
20,00,000 Equity Shares of ₹ 10 each fully paid	2,00,00,000
Reserve and Surplus	
General Reserve	25,00,000
Securities Premium	22,00,000
Profit and Loss Account	15,00,000
	62,00,000

(3) Fixed Assets

Particulars	₹
(a) *Tangible Assets :*	
Land and Building	73,60,000
Plant and Machinery	1,50,00,000
Furniture and Fittings	25,00,000
Motor Vehicles	25,00,000
	2,73,60,000

At a meeting of the shareholders, the following decisions were taken :

(i) 15% of the paid-up shares would be bought back @ ₹ 16 each.

(ii) 10% Debentures of ₹ 20,00,000 at a premium of 15% would be issued to finance the buy back.

(iii) General reserve would be used leaving a balance of ₹ 10,00,000.

(iv) Investments worth ₹ 20,00,000 would be sold out for ₹ 28,00,000.

Pass necessary journal entries and also prepare the Balance Sheet after the buy back.

[C.S. (Inter) — Adapted]

Guide to Answers

Multiple Choice

1. B; 2. C; 3. C; 4. C; 5. D; 6. C; 7. D; 8. D; 9. C; 10. B.

Practical Questions

5. Maximum number of shares than can be bought back is 12,500 shares.
6. Balance Sheet total ₹ 4,35,00,000.

5

Redemption of Preference Shares

Introduction

Redemption is the process of repaying an obligation, usually at prearranged amounts and times. The conditions of the issue of preference shares include a call provision, i.e., a contract giving the right to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that holders will at some future date be repaid the amount which they invested in the company. The redemption date is the maturity date, which specifies when repayment takes place and is usually printed on the preference share certificate. By the process of redemption, a company can also adjust its financial structure, for example, by eliminating preference shares and replacing those with other securities if future growth of the company makes such change advantageous.

Issue and Redemption of Preference Shares Under The Companies Act, 2013

The issue and redemption of preference shares are governed by Section 55 of the Companies Act, 2013. As per the provision of this section :

(1) No company limited by shares shall, after the commencement of this Act, issue any preference shares which are ***irredeemable***.

(2) A company limited by shares may, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding ***twenty*** years from the date of their issue.

Rule 10 of the Companies (Share Capital and Debentures) Rules, 2014 states that a company engaged in the setting up and dealing with infrastructural projects may issue preference shares for a period *exceeding twenty years but not exceeding thirty years*, subject to the redemption of a minimum ***ten per cent*** of such preference shares per year from the twenty-first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.

Rules Relating to Redemption of Preference Shares

Rule 9(6) of the Companies (Share Capital and Debentures) Rules, 2014 states that :

A company may redeem its preference shares only on the terms on which they were issued or as varied after due approval of preference shareholders under Section 48 of the Act and the preference shares may be redeemed:

(a) at a fixed time or on the happening of a particular event;
(b) any time at the company's option; or
(c) any time at the shareholder's option.

Conditions for Redemption of Preference Shares

Section 55, Sub-section 2 of the Companies Act, 2013 provides that :

(a) no such shares shall be redeemed except ***out of the profits*** of the company which would otherwise be available for dividend or ***out of the proceeds*** of a fresh issue of shares made for the purposes of such redemption;

(b) no such shares shall be redeemed unless they are fully paid;

(c) where such shares are proposed to be redeemed out of the profits of the company, there shall, out of such profits, be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve, to be called the Capital Redemption Reserve Account, and the provisions of this Act relating to reduction of share capital of a company shall, except as provided in this section, apply as if the Capital Redemption Reserve Account were paid-up share capital of the company; and

(d) (i) in case of such class of companies, as may be prescribed and whose financial statement comply with the ***Accounting Standards*** prescribed for such class of companies under section 133, the premium, if any, payable on redemption shall be provided for ***out of the profits*** of the company, before the shares are redeemed;

Provided also that premium, if any, payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for out of the profits of the company or out of the company's Securities Premium Account, before such shares are redeemed.

(ii) in a case not falling under sub-clause (i) above, the premium, if any, payable on redemption shall be provided for out of the profits of the company or out of the company's Securities Premium Account, before such shares are redeemed.

In the context of the above provisions of The Companies Act, 2013, the following points are to be noted:

(1) The companies whose financial statements comply with accounting standards, should pay 'premium on redemption' out of profits only. (It is worth mentioning here that in the Companies Act, 1956, there were option to pay 'such premium' out of profit or securities premium. However, in the Companies Act, 2013 that option of payment premium on redemption of preference shares out of securities premium is not there at all.)

Throughout this Chapter, we will consider that all company's financial statements comply with Accounting Standard. Therefore, the premium payable on redemption have been adjusted against 'profit' in all the Illustrations and Practical Questions.

(2) When preference shares are redeemed out of profit, an amount equal to nominal (face) value of the shares redeemed must be transferred to '***Capital Redemption Reserve***'. This Capital Redemption Reserve should be treated as paid-up share capital of the company.

"The restrictions on utilisation of securities premium deserve to be mentioned separately. The prescribed class of companies will be able to utilise the securities premium only to issue fully paid equity bonus shares, writing off expenses / commission paid / discount allowed pertaining to issuance of equity shares and buy back of its shares. This would mean that such prescribed companies will not be able to utilise the securities premium to adjust premium payable on redemption of redeemable preference shares or debentures. The gain or loss on such redemption would be routed through statement of profit and loss which is in line with international standards." ***[Source : Accounting and Auditing Update, December 2014,***

The Capital Redemption Reserve Account may, notwithstanding anything in this section, be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Where a company is not in a position to redeem any preference shares or to pay dividend, if any, on such shares in accordance with the terms of issue (such shares hereinafter referred to as 'unredeemed preference shares'), it may, with the consent of the holders of ***three-fourths*** in value of such preference shares and with the approval of the Tribunal on a petition made by it in this behalf, issue further redeemable preference shares equal to the amount due, including the dividend thereon, in respect of the unredeemed preference shares, and on the issue of such further redeemable preference shares, the unredeemed preference shares shall be deemed to have been redeemed :

Provided that the Tribunal shall, while giving approval under this sub-section, order the redemption forthwith of preference shares held by such persons who have ***not consented*** to the issue of further redeemable preference shares.

Explanation— For the removal of doubts, it is hereby declared that the issue of further redeemable preference shares or the redemption of preference shares under this section shall not be deemed to be an increase or, as the case may be a reduction, in the share capital of the company.

Methods of Redemption

The 'gap' created in the company's capital because of the redemption of redeemable preference shares must be filled-in by:

(a) the proceeds of a fresh issue of shares;
(b) the capitalization of undistributed profits; or
(c) a combination of (a) and (b).

(a) Fresh Issue of Shares

One of the prescribed methods for redemption is to use ***the proceeds of a fresh issue of shares***.

A Company can issue new shares (equity share or preference share) and the proceeds from such new shares can be used for redemption of preference shares. However, ***the proceeds from issue of debentures cannot be utilized for this purpose***.

Meaning of the Word 'Proceeds'

The Companies Act, 2013 has not defined the word 'Proceeds'. Therefore, the dictionary meaning of the word is important. Some of the meaning is given below :

As regards the meaning of the word 'proceeds', the Webster's New Collegiate Dictionary states, 'the total amount brought in and also the net amount received (as for a cheque or from an insurance settlement) after deduction of any discount or charges'. The Act is supposed to use technical term, if necessary. Hence Stroud's Judicial Dictionary (Second cumulative supplement) has the following on 'proceeds' :

'All the rest and residue of the proceeds of such sale as above-said including money left by the testator in the Bank. [Wilkinson vs O' Sullivan (1953)]'.

In respect of proceeds of fresh issue of shares, the following points are important :

(1) ***When shares are issued at par*** : The total amount brought in by the shareholders (both equity and preference) will be treated as proceeds.
(2) ***When shares are issued at premium*** : A problem arises when a fresh issue is made for the purpose of redemption of preference shares at a 'premium'. A critical perusal of both the general and technical meanings of the word 'proceeds' would suggest that the proceeds of the issue would also include the money received on account of securities premium, too. As per the provisions of Section 52(2) and 52(3) of the Companies Act, 2013 the securities premium can be utilised only for the following purposes :
    (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
    (b) in writing off the preliminary expenses of the company;
    (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

The Securities Premium Account may, be applied by such class of companies, as may be prescribed and whose financial statements comply with the accounting standards prescribed for such class of companies under Section 133,—

(a) in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or

(b) in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company; or

(c) for the purpose of its own shares or other securities under section 68.

Any other way, except the above prescribed ways, in which Securities Premium Account is utilised will be contravention of law. It is interesting to note that clause (d) above allows premium on redemption of preference shares or debentures to be adjusted against Securities Premium Account (in some cases), but the redemption itself cannot be financed out of Securities Premium Account. Therefore, we can conclude that securities premium money out of fresh issue ***cannot be treated as 'proceeds'*** for the purpose of redemption of preference shares.

Points to Remember :

(1) Securities premium money out of a fresh issue cannot be treated as proceeds.

(2) 'Proceeds' in connection with issue of shares at a premium would mean only the amount received, in respect of face value.

(3) Premium payable on redemption must be provided out of Profit and Loss Account by such class of companies whose financial statements comply with the Accounting Standards

(4) Both the resolution for redemption of preference shares and the issue of new shares are passed simultaneously.

Grounds for Issue of New Equity Shares

A company may prefer issue of new equity shares for the following reasons :

(a) when the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares which carry a fixed rate or amount of dividend.

(b) when the balance of profit, which would otherwise be available for dividend, is insufficient.

(c) when the liquidity position of the company is not good enough.

Following are the advantages of redemption of preference shares by the issue of equity shares:

(1) No cash outflow of money — now or later.

(2) New equity shares may be issued at a premium.

(3) No capital gains tax for shareholders.

(4) Shareholders retain their equity interest.

The disadvantages are :

(1) There is a possibility of dilution of future earnings per share;

(2) Share holdings in the company are changed.

Accounting Entries

1. When new shares are issued at par

Bank Account Dr.

To Equity Share Application Account

(Being application money received on ... shares @ ₹ ... each)

Equity Share application Account Dr.

To Share Capital Account

(Being the issue of ... shares of ₹ ... each for the purpose of redemption of preference shares, as per Board's Resolution No ... dated ...)

2. When new shares are issued at a premium

Bank Account Dr.
To Equity Share Application Account
(Being application money received on ... shares @ ₹ ... each)
Bank Account Dr.
To Share Capital Account
To Securities Premium Account
(Being the issue of ... shares of ₹ ... each at a premium of ₹ ... each for the purpose of redemption of preference shares as per Board's Resolution No ... dated ...)

3. When shares are redeemed at par

Redeemable Preference Share Capital Account Dr.
To Preference Shareholders Account

4. When shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr.
Premium on Redemption of Preference Shares Account Dr.
To Preference Shareholders Account

5. When payment is made to preference shareholders

Preference Shareholders Account Dr.
To Bank Account

6. For adjustment of premium on redemption

Statement of Profit and Loss Dr.
To Premium on Redemption of Preference Shares Account
(Being the premium on redemption adjusted against profit and loss balance)

Illustration 1

Hindustan Construction Company Ltd,had 5,000 8% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at par.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution

In the books of Hindustan Construction Company Limited
Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
	Bank A/c Dr.	5,00,000	
	To Equity Share Application A/c		5,00,000
	(Being the application money received on 50,000 equity shares @ ₹ 10 each)		
	Equity Share Application A/c Dr.	5,00,000	
	To Equity Share Capital A/c		5,00,000
	(Being the issue of 50,000 Equity Shares of ₹ 10 each at par for the purpose of redemption of preference shares, as per Board's Resolution No. ... dated ...)		
	8% Redeemable Preference Share Capital A/c Dr.	5,00,000	
	To Preference Shareholders A/c		5,00,000
	(Being the amount payable on redemption of pref. shares transferred to Preference Shareholders Account)		
	Preference Shareholders A/c Dr.	5,00,000	
	To Bank A/c		5,00,000
	(Being the amount paid on redemption of preference shares)		

Illustration 2

M.M.C. Ltd had 10,000 10% Redeemable Preference Shares of ₹ 100 each, fully paid up.

The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution **In the books of MMC Limited**

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	12,00,000	
	To Equity Share Application A/c			12,00,000
	(Being the application money received on 1,00,000 Equity Shares @ ₹ 12 each)			
	Equity Share Application A/c	Dr.	12,00,000	
	To Equity Share Capital A/c			10,00,000
	To Securities Premium A/c			2,00,000
	(Being the issue of 1,00,000 Equity Shares of ₹ 10 each at a premium of ₹ 2 per share as per Board's Resolution No. ... dated ...)			
	10% Redeemable Preference Share Capital A/c	Dr.	10,00,000	
	To Preference Shareholders A/c			10,00,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c	Dr.	10,00,000	
	To Bank A/c			10,00,000
	(Being the amount paid on redemption of preference shares)			

Tutorial Note : Amount required for redemption is ₹ 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to ₹ 10,00,000. ***Premium received on new issue can not be used to finance the redemption***.

(b) The Capitalisation of Undistributed Profits

Another method for redemption of preference shares, allowed by the Companies Act, 2013 is to use the distributable profits instead of issuing new shares . When shares are redeemed by utilizing distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by taking away a part of the distributable profit. In other words, some of the distributable profits are 'frozen' to ensure that it can never be distributed to shareholders as dividend.

In this connection, the provision of section 52(2)(c) of the Companies Act, 2013 is very important. This section states that 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall, out of profits which would otherwise have been available for dividend, be transferred to a reserve fund, to be called the capital redemption reserve account, a sum equal to the nominal amount of the shares redeemed;......'

The advantages of capitalisation of undistributed profits are :

(1) No change in the percentage share holdings of the company;

(2) Future earnings are not diluted;

(3) Surplus funds can be used.

The disadvantages are :

(1) There may be a reduction in liquidity;

(2) Capital gains tax liability for preference shareholders.

Accounting Entries

1. When shares are redeemed at par

Redeemable Preference Share Capital Account Dr.
To Preference Shareholders Account
(Being amount payable on redemption of preference shares transferred to Preference Shareholders A/c.)

2. When shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr.
Premium on Redemption of Preference Shares Account Dr.
To Preference Shareholders Account
(Being the amount payable on redemption transferred to Preference Shareholders Account)

3. When payment is made to preference shareholders

Preference Shareholders Account Dr.
To Bank Account
(Being the payment to preference shareholders as per terms)

4. For adjustment of premium on redemption

Profit and Loss Account Dr.
To Premium on Redemption of Preference Shares Account
(Being the premium on redemption adjusted against Profit and Loss Account)

5. For transferring nominal amount of shares redeemed to capital redemption reserve account

General Reserve Account Dr.
Profit and Loss Account Dr.
To Capital Redemption Reserve Account
(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)

Issue of Bonus Shares from Capital Redemption Reserve

When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account. Sometimes, bonus shares are issued by utilising this capital redemption reserve and other reserves. In that case, the entries will be as follows :

Capital Redemption Reserve Account Dr.
Other Reserve Account Dr.
To Bonus to Shareholders Account
(Being the amount appropriated for issue of bonus shares).
Bonus to Shareholders Account Dr.
To Equity Share Capital Account
(Being the utilisation of bonus dividend for issue of equity shares)

Logic Behind the Creation of a Capital Redemption Reserve

Capital Redemption Reserve is created for the following reasons:

(1) The most important purpose for the creation of a Capital Redemption Reserve is to maintain the capital intact. Emphasis has been put on the ***'capital maintenance'*** aspect to safeguard the ***'scale of capital'*** to which the company was geared just before redemption.

The issue of preference shares is not very popular option for long-term capital of the company. However, some companies issue preference shares for making-up shortage of capital, required for doing business at a certain budgeted level of activities. We know that these preference shares must be redeemed before the expiry of 20 / 30 years as the case may be. In that case, shortage of capital oriented problems may re-appear. To protect the scale of capital, the Companies Act, 2013 has given two options to the company :

(i) Bring new capital by issue of shares; or
(ii) Transfer from divisible profit an amount equal to face value of shares redeemed to Capital Redemption Reserve.

By creating Capital Redemption Reserve, the amount of divisible profit will be reduced and capital of the company will remain the same. It may be recalled that the Capital Redemption Reserve can only be used for issue of fully paid-up ***bonus shares***.

(2) The another reason for the creation of a capital redemption is for the protection of the company's lenders / creditors, since the directors of the company may distribute divisible profits by way of dividend.

Consider the following example :

Balance Sheet of X Ltd. as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,00,000
(b) Reserves and Surplus (Profit and Loss Balance)		1,50,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		1,60,000
(4) Current Liabilities :		—
TOTAL		6,10,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		2,10,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,00,000
(c) Trade Receivables		1,00,000
(d) Cash and Cash Equivalents		2,00,000
TOTAL		6,10,000

Notes to Accounts :

(1) Share Capital

Particulars	₹	₹
Authorised Capital :		
30,000 Equity Shares of ₹ 10 each	3,00,000	
5,000 Redeemable Preference Shares of ₹ 10 each	50,000	3,50,000
Issued, Subscribed and Paid-up Capital :		
20,000 Equity Shares of ₹ 10 each	2,00,000	
5,000 Redeemable Preference Shares of ₹ 10 each	50,000	2,50,000

As per the terms and conditions of issue, preference shares were redeemable on 1st January, 2017.

Now, the effects of the transfer to a capital redemption reserve can be demonstrated in the following manner:

Statement showing the amount available to Long-term Lenders

		31st Dec. 2016	1st Jan. 2017 without any transfer to Capital Redemption Reserve	1st Jan, 2017 after transfer to Capital Redemption Reserve
Total assets	(₹)	6,10,000	*5,60,000	*5,60,000
Less: Retained profits legally available for distribution to shareholders by way of dividend	(₹)	1,50,000	1,50,000	**1,00,000
Net amount available to lenders	(₹)	4,60,000	4,10,000	4,60,000

*Fixed assets ₹ 2,10,000 + Inventories ₹ 1,00,000 + Trade Debtors ₹ 1,00,000 + Cash ₹ 1,50,000 (after payment to preference shareholders) = ₹ 5,60,000.

**Total profit ₹ 1,50,000 less ₹ 50,000 transferred to Capital Redemption Reserve = ₹ 1,00,000.

It should be noted that the position of the lenders are exactly the same as they were before the preference shares were redeemed, when the transfer has been made to Capital Redemption Reserve Account. Therefore, we can conclude that the transfer to Capital Redemption Reserve protects the interest of the lenders.

Illustration 3

The following are the extracts from the Balance Sheet of A. Ltd as on 31st December, 2016.

Share Capital : 4
40,000 Equity shares of ₹ 10 each fully paid — ₹ 4,00,000;
1,000 10% Redeemable Preference shares of ₹ 100 each fully paid – ₹ 1,00,000;
Reserve & Surplus :
Capital reserve – ₹ 50,000;
Securities premium — ₹ 50,000;
General reserve — ₹ 75,000;
Profit and loss account — ₹ 35,000.

On 1st January 2017, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution **In the books of A Limited**
Journal **Dr.** **Cr.**

Date	Particulars		₹	₹
2017 Jan. 1	10% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	To Preference Shareholders A/c			1,00,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
Jan. 1	Preference Shareholders A/c	Dr.	1,00,000	
	To Bank A/c			1,00,000
	(Being the amount paid on redemption of preference shares)			
Jan. 1	General Reserve A/c	Dr.	75,000	
	Profit & Loss A/c	Dr.	25,000	
	To Capital Redemption Reserve A/c			1,00,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Tutorial Note : Securities premium cannot be utilized for transfer to Capital Redemption Reserve because dividend cannot be paid out of Securities Premium Account.

(c) A Combination of Both the Methods

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer to be made from distributable profits (Profit & Loss Account, general reserve and other free reserves) to Capital Redemption Reserve Account.

Formula:

	₹
(i) **Amount to be Transferred to Capital Redemption Reserve**	
Face value of shares redeemed	***
Less: Proceeds from new issue	***
	***

	₹
(ii) **'Proceeds' to be Collected from New Issue**	
Face value of shares redeemed	***
Less: Profits available for distribution as dividend	***
	***

Illustration 4

Calcutta Limited had 3,000, 12% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company had to redeem these shares at a premium of 10 %.

It was decided by the company to issue the following:
(i) 25,000 Equity Shares of ₹ 10 each at par.
(ii) 1,000 14% Debentures of ₹ 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits.

Show Journal Entries in the books of the company.

Solution

In the books of Calcutta Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being the issue of 25,000 Equity Shares of ₹ 10 each at par as per Board's Resolution No.... dated...)			
	Bank A/c	Dr.	1,00,000	
	To 14% Debentures A/c			1,00,000
	(Being the issue of 1,000 Debentures of ₹ 100 each as per Board's Resolution No. .... dated ....)			
	12% Redeemable Preference Share Capital A/c	Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	30,000	
	To Preference Shareholders A/c			3,30,000
	(Being the the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	3,30,000	
	To Bank A/c			3,30,000
	(Being the amount paid on redemption of preference shares)			
	Profit & Loss A/c	Dr.	30,000	
	To Premium on Redemption of Preference Shares A/c			30,000
	(Being the adjustment of premium on redemption against Profit & Loss Account)			
	Profit & Loss A/c	Dr.	50,000	
	To Capital Redemption Reserve A/c (Note 1)			50,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Working Note : (1) Amount to be Transferred to Capital Redemption Reserve Account

Face value of shares to be redeemed	₹ 3,00,000
Less: Proceeds from new issue	₹ 2,50,000
	₹ 50,000

Illustration 5

The Balance Sheet of ABC Ltd., as on 31.12.2016 was as follows :

Balance Sheet of ABC Ltd. as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,98,000
(b) Reserves and Surplus	(2)	51,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		21,000
TOTAL		2,70,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		1,30,000
(b) Non-current Investments		30,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		20,000
(c) Trade Receivables		50,000
(d) Cash and Cash Equivalents		40,000
TOTAL		2,70,000

Notes to Accounts :

(1) Share Capital

Particulars	₹	₹
Authorised Capital :		
15,000 Equity Shares of ₹ 10 each	1,50,000	
1,000 Redeemable Preference Shares of ₹ 100 each	1,00,000	2,50,000
Issued, Subscribed and Paid-up Capital :		
10,000 Equity Shares of ₹ 10 each		1,00,000
1,000 Redeemable Preference Shares of ₹ 100 each	1,00,000	
Less: Calls-in-arrear (₹ 20 x 100)	2,000	98,000
		1,98,000
(2) Reserve and Surplus		
General Reserve		29,000
Profit and Loss Account		22,000
		51,000

On 1.1.2017 fixed assets costing ₹ 20,000 were sold for ₹ 18,000. On that date it was decided to redeem the preference shares at a premium of 20% by issuing sufficient number of equity shares subject to leaving a balance of ₹ 10,000 in General Reserve. All payments were made except to holders of 50 shares who could not be traced.

You are required to:

(i) pass necessary journal entries;

(ii) prepare a Balance Sheet after redemption.

Solution

In the books of ABC Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017	Bank A/c	Dr.	18,000	
Jan. 1	Loss on Sale of Fixed Assets A/c	Dr.	2,000	
	To Fixed Assets A/c			20,000
	(Being the sale of fixed assets costing ₹ 20,000 for ₹ 18,000)			
	Profit and Loss A/c	Dr.	2,000	
	To Loss on Sale of Fixed Assets A/c			2,000
	(Being loss on sale of fixed assets transferred to Profit and Loss Account)			
	Redeemable Preference Shares Capital A/c (Note 1)	Dr.	90,000	
	Premium on Redemption of Preference Shares A/c (Note 1)	Dr.	18,000	
	To Preference Shareholders A/c			1,08,000
	(Being the amount of payable on redemption of 900 preference shares at a premium of 20%)			
	Profit and Loss A/c	Dr.	18,000	
	To Premium on Redemption of Preference Shares A/c			18,000
	(Being the adjustment of premium on redemption against Profit and Loss Account)			
	Bank A/c	Dr.	69,000	
	To Equity Shares Application A/c			69,000
	(Being application money received for 6,900 equity shares @ ₹ 10 each)			
	Equity Shares Application A/c	Dr.	69,000	
	To Equity Shares Capital A/c			69,000
	(Being the transfer of application money to Equity Shares Capital Account as per Board's Resolutio No. ... dated ...)			
	Preference Shareholders A/c	Dr.	1,02,000	
	To Bank A/c			1,02,000
	(Being the amount paid to 850 preference shareholders @ ₹ 120 per share)			
	Profit and Loss A/c	Dr.	2,000	
	General Reserve A/c	Dr.	19,000	
	To Capital Redemption Reserve A/c			21,000
	(Being the necessary amount transferred to Capital Redmeption Reserve Account as per the requirement of the Act)			

Balance Sheet of ABC Ltd. as at 31st January, 2017

Particulars (1)	Note No. (2)	Amount (₹) (3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,77,000
(b) Reserves and Surplus	(2)	31,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		21,000
(c) Other Current Liabilities		6,000
(d) Short-term Provisions		—
TOTAL		2,35,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets (1,30,000 – 20,000)		1,10,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		30,000
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		20,000
(c) Trade Receivables		50,000
(d) Cash and Cash Equivalents		25,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		2,35,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
15,000 Equity Shares of ₹ 10 each	1,50,000
1,000 Redeemable Preference Shares of ₹ 100 each	1,00,000
	2,50,000
Issued, Subscribed and Paid-up Capital :	
16,900 Equity Shares of ₹ 10 each fully paid	1,69,000
100 Redeemable Preference Shares of ₹ 100 each ₹ 80 paid-up	8,000
	1,77,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	10,000
Capital Redemption Reserve	21,000
	31,000

Working Notes :

(1) Total number of Redeemable Preference Shares are 1,000, out of which 100 shares cannot be redeemed as those are partly paid-up. Therefore, total number of preference shares which can be redeemed as per the provisions of Companies Act, 2013 = 1,000 – 100 = 900.

Premium on Redemption = ₹ 90,000 × 20% = ₹ **18,000**.

(2) Calculation of Number of Equity Shares to be Issued

	₹	₹
Face value of shares redeemed		90,000
Less: Amount could be transferred to CRR from difference sources		
(i) General Reserve (29,000 – 10,000)	19,000	
(ii) Profit and Loss Balance (22,000 – 2,000 – 18,000)	2,000	21,000
Proceeds from Fresh Issue		69,000

No. of equity shares to be issued = 69,000 / 10 = 6,900 shares.

(3) Calculation of Cash Balance after Redemption of Preference Shares

	₹
Opening balance	40,000
Add: Sale of fixed assets	18,000
Issue of equity shares	69,000
	1,27,000
Less: Cash paid to preference shareholders	1,02,000
	25,000

Illustration 6

The following balances were extracted from the books of Bombay Ltd. as on 30 June, 2017:

	₹
4,000, 8% Redeemable Preference Shares of ₹ 100 each fully called up	4,00,000
Less: Calls-in-arrear at ₹ 20 per share on 600 shares	12,000
	3,88,000
Profit and Loss Account Balance	1,00,000
Capital Reserve	20,000

The preference shares were redeemed on 1 July, 2017 at a premium of ₹ 5 per share. The company issued such further equity shares of ₹ 10 each — as were necessary for the purpose of redeeming the preference shares — which were fully subscribed and duly allotted.

You are required to show the journal entries showing the transactions relating to the redemption of shares and the relevant extracts in the liabilities side of the Balance Sheet after such redemption.

Solution

In the books of Bombay Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 July 1	8% Redeemable Preference Shares Capital A/c (Note 1)	Dr.	3,40,000	
	Premium on Redemption of Preference Shares A/c	Dr.	17,000	
	To Preference Shareholders A/c			3,57,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Profit and Loss A/c	Dr.	17,000	
	To Premium on Redemption of Prererence Shares A/c			17,000
	(Being the premium payable on redemnption adjusted against Profit and Loss Account)			
	Profit and Loss A/c (Note 2)	Dr.	83,000	
	To Capital Redemption Reserve A/c			83,000
	(Being the balance amount of Profit and Loss Account transferred to Capital Redmeption Reserve Account)			
	Bank A/c (Note 3)	Dr.	2,57,000	
	To Equity Shares Application A/c			2,57,000
	(Being the application money received for 25,700 equity shares @ ₹ 10 each)			
	Equity Shares Application A/c	Dr.	2,57,000	
	To Equity Shares Capital A/c			2,57,000
	(Being the issue of 25,700 equity shares of ₹ 10 each as per Board's Resolution No. ... dated ...)			
	Preference Shareholders A/c	Dr.	3,57,000	
	To Bank A/c (Note 4)			3,57,000
	(Being the amount paid on redemption of preference shares)			

Balance Sheet of Bombay Ltd. Ltd. as at 31st July, 2017 [Extract]

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,61,800
(b) Reserves and Surplus	(2)	1,03,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		

(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
25,700 Equity Shares of ₹ 10 each fully paid	2,57,000
600, 8% Redeemable Preference Shares of ₹ 100 each ₹ 80 paid-up	4,800
	2,61,800

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve	83,000
Capital Reserve	20,000
	1,03,000

Working Notes :

(1) Total number of Redeemable Preference Shares are 4,000, out of which 600 shares are partly paid-up. Therefore, number of preference shares eligible for redemption = 4,000 – 600 = **3,400 shares.**

(2) It has been assumed that the entire balance (after adjusting premium on redemption of preference shares) of profit and losse has been utilised for the purpose of redemption of preference shares. So, the balance of ₹ 83,000 has been transferred to Capital Redemption Reserve Account. It is to be noted that the Capital Reserve cannot be used for the purpose of creation of CRR.

(3) Calculation of Amount to be Arranged by Issue of Equity Shares

	₹
Face value of preference shares redeemed	3,40,000
Less: Amount transferred to CRR from Profit and Loss Balance (1,00,000 – 17,000)	83,000
Amount from Fresh Issue of Equity Shares	2,57,000

Illustration 7

The books of XYZ Ltd. showed the following balances on 31st December, 2016 :

	₹
15,000 Equity shares of ₹ 10 each fully paid	1,50,000
2,500, 10% Redeemable Preference Shares of ₹ 100 each fully paid	2,50,000
500, 8% Redeemable Preference Shares of ₹ 100 each, ₹ 70 per up	35,000
General Reserve	75,000
Profit and Loss Account	1,60,000
Securities Premium	15,000
Investment	1,20,000
Cash at Bank	39,600

On 1st January, 2017 the Board of Directors decided to redeem the Preference Shares at a premium of 8%. In order to pay off Preference Shareholders the company also decided to sell the investments, use company's fund and to raise the balance by the issue of sufficient number of Equity Shares of ₹ 10 each at a premium of ₹ 1 per share subject to leaving a minimum bank balance of ₹ 9,600 after such redemption. Investments were sold at ₹ 1,08,000.

Show the necessary Journal Entries to record the transactions.

Solution

In the books of XYZ Ltd

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 Jan. 1	10% Redeemable Preference Shares Capital A/c	Dr.	2,50,000	
	Premium on Redemption of Preference Shares A/c	Dr.	20,000	
	To Preference Shareholders A/c			2,70,000
	(Being the redemption of 2,500, 10% Redeemable Preference Shares of ₹ 100 each at a premium of 8% as per Board's Resolution No. ... dated ...)			
	Bank A/c	Dr.	1,08,000	
	Loss on Sale of Investment A/c	Dr.	12,000	
	To Investmentes A/c			1,20,000
	(Being the sale of investment at a loss of ₹ 12,000)			

Profit and Loss A/c Dr. To Loss on Sale of Investment A/c (Being the loss on sale of investment transferred to Profit and Loss Account)	12,000	12,000
Bank A/c (Note 1) Dr. To Equity Shares Application A/c (Being application money received for 12,000 equity shares of ₹ 11 each including premium of ₹ 1 per share)	1,32,000	1,32,000
Equity Shares Application A/c Dr. To Equity Shares Capital A/c To Securities Premium A/c (Being the transfer of application money on 12,000 shares @ ₹ 10 each to Equity Shares Capital Account and @ ₹ 1 to Securities Premium Account as per Board's Resolution No. ... dated ...)	1,32,000	1,20,000 12,000
Preference Shareholders A/c Dr. To Bank A/c (Being the amount paid to Preference Shareholders for redemption of preference shares)	2,70,000	2,70,000
Profit and Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being the adjustment of premium on redemption against Profit and Loss Account balance)	20,000	20,000
General Reserve A/c (Note 3) Dr. To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	1,30,000	1,30,000

Working Notes :

(1) Calculation of Number of Shares to be Issued

	₹
Cash balance at present	39,600
Add: Sale of investments	1,08,000
	1,47,600
Less: Cash balance to be maintained	9,600
Cash available for redemption of preference shares	1,38,000
Cash required for redemption	2,70,000
Less: Cash available	1,38,000
Cash from New Issue of Shares	1,32,000

No. of equity shares to be issued = 1,32,000 / 11 = 12,000 shares.

(2) Premium on Redemption of Preference Shares to be adjusted against Profit and Loss Account balance 20,000

Note : Premium from new issue cannot be used as per the provisions of the Act.

(3) Amount to be transferred to Capital Redemption Reserve

Face value of shares redeemed	2,50,000
Less: Proceeds from issue of equity shares (**excluding premium**)	1,20,000
	1,30,000

Illustration 8

The following is the Balance Sheet of Basak Ltd. as at 31st March, 2017 :

Balance Sheet of Basak Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus	(2)	2,10,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		10,000
TOTAL		4,20,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		2,00,000

(2) Current Assets :		
(a) Current Investments		1,00,000
(b) Inventories		25,000
(c) Trade Receivables		27,000
(d) Cash and Cash Equivalents		68,000
TOTAL		4,20,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
20,000 Equity Shares of ₹ 10 each	2,00,000
10,000, 10% Preference Shares of ₹ 10 each	1,00,000
	3,00,000
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 10 each	1,00,000
10,000, 10% Preference Shares of ₹ 10 each	1,00,000
	2,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	1,20,000
Securities Premium	70,000
Profit and Loss Account	20,000
	2,10,000

The company decided to redeem the 10% Preference Shares on the following terms :

(i) Preference Shares are to be redeemed at a premium of 10%.

(ii) To meet the cash requirements of redemption, the company sold a portion of the investments, so as to leave a minimum cash balance of ₹ 30,000.

(iii) Investments were sold at 90% of cost.

(iv) After the redemption, the company issued bonus shares in the ratio of one share for every equity shares held.

Give necessary Journal Entries in the books of the Company.

Solution

In the books of Basak Ltd.
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017	.Bank A/c	Dr.	72,000	
Mar. 31	Loss on Sale of Investment A/c	Dr.	8,000	
	To Investment A/c			80,000
	(Being the sale of investment at a loss of ₹ 8,000)			
	Profit and Loss A/c	Dr.	8,000	
	To Loss on Sale of Investment A/c			8,000
	(Being the loss on sale of investment transferred to Profit and Loss Account			
	10% Preference Shares Capital A/c	Dr.	1,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	10,000	
	To Preference Shareholders A/c			1,10,000
	(Being the amount payable on redemption of 10,000, 10% Preference Shares of ₹ 10 each at a premium of 10%)			
	Preference Shareholders A/c	Dr.	1,10,000	
	To Bank A/c			1,10,000
	(Being the amount paid to Preference Shareholders for redemption of shares)			
	General Reserve A/c	Dr.	1,00,000	
	To Capital Redemption Reserve A/c			1,00,000
	(Being the trasnfer of necessary amount to Capital Redemption Reserve Account as per the requirement of the Act)			
	Profit and Loss A/c	Dr.	10,000	
	To Premium on Redemption of Preference Shares A/c			10,000
	(Being the premium on redemption of preference shares adjusted against Profit and Loss Account)			
	Capital Redmeption Reserve A/c	Dr.	1,00,000	
	To Bonus to Shareholders a/c			1,00,000
	(Being the issue of bonus shares in the ratio of 1 : 1 as per Board's Resolution No. ... dated ...)			
	Bonus to Shareholders A/c	Dr.	1,00,000	
	To Equity Shares Capital A/c			1,00,000
	(Being the issue of 10,000 equity shares as bonus as per Board's Resolution No. ... dated ...)			

Working Notes

(1) Calculation of Sale Proceeds from Investment

	₹
Amount required for Redemption of Preference Shares	1,10,000
Less: Cash available (68,000 – 30,000)	38,000
Cash from sale of investments	72,000

(a) Cost of investment sold = ₹ 72,000 / 90% = ₹ 80,000.
(b) Loss on sale of investment = ₹ 80,000 – 72,000 = ₹ 8,000.

Illustration 9

The Balance Sheet of Green Ltd. as at 31.03.2017 is as follows :

Balance Sheet of Green Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,90,000
(b) Reserves and Surplus	(2)	1,30,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings – Unsecured		80,000
TOTAL		5,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		4,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		50,000
(c) Trade Receivables		40,000
(d) Cash and Cash Equivalents		10,000
TOTAL		5,00,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
25,000 Equity Shares of ₹ 10 each		2,50,000
10,000 Redeemable Preference Shares of ₹ 100 each		1,00,000
		3,50,000
Issued, Subscribed and Paid-up Capital :		
20,000 Equity Shares of ₹ 10 each	2,00,000	
Less: Calls-in-arrear (@ ₹ 2)	10,000	1,90,000
1,000, 14% Preference Shares of ₹ 100 each		1,00,000
		2,90,000

(2) Reserve and Surplus

Particulars	₹
Investment Allowance Reserve	40,000
Development Rebate Reserve	20,000
Workmen Compensation Fund	10,000
Profit and Loss Account	48,000
Dividend Equalisation Fund	12,000
	1,30,000

The Board decided to redeem the preference shares on 1.4.2017 on the following conditions :

(i) Issue 4,000 equity shares and ₹ 50,000, 10% debentures.
(ii) Redeem preference shares at a premium of 10%.
(iii) Raise necessary bank loan to provide funds for redemption and to have ₹ 26,000 balance.
(iv) Admit a claim of ₹ 4,000 for workmen compensation.
(v) Utilise ₹ 10,000 out of Development Rebate Reserve for the purpose.

Give necessary Journal Entries and prepare Balance Sheet after redemption of preference shares assuming that holders of 100 preference shares could not be traced by the company.

Solution

In the books of Green Ltd
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 April 1	14% Preference Shares Capital A/c	Dr.	1,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	10,000	
	To Preference Shareholders A/c			1,10,000
	(Being the amount payable on redemption of preference shares)			
	Profit and Loss A/c	Dr.	10,000	
	To Premium on Redemption of Preference Shares A/c			10,000
	(Being the premium payable on redemption adjusted against Profit and Loss Account)			
	Workmen Compensation Fund A/c	Dr.	4,000	
	To Claim for Compensation A/c			4,000
	(Being admission of claim by the workers)			
	Development Rebate Reserve A/c	Dr.	10,000	
	Dividend Equalisation Fund A/c	Dr.	12,000	
	Profit and Loss A/c	Dr.	38,000	
	To Capital Redemption Reserve A/c (Note 1)			60,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	Bank A/c	Dr.	40,000	
	To Equity Shares Application A/c			40,000
	(Being application money received on 4,000 equity shares @ ₹ 10 each)			
	Equity Shares Application A/c	Dr.	40,000	
	To Equity Shares Capital A/c			40,000
	(Being the issue of 4,000 equity shares of ₹ 10 each fully paid-up as per Board's Resolution No. .. dtd. ...)			
	Bank A/c	Dr.	50,000	
	To 10% Debentures Application A/c			50,000
	(Being application money received for 10% Debentures)			
	10% Debentures Application A/c	Dr.	50,000	
	To 10% Debentures A/c			50,000
	(Being issue of debentures of ₹ 50,000 as per Board's Resolution No. .. dtd. ...)			
	Bank A/c (Note 1)	Dr.	25,000	
	To Bank Loan A/c			25,000
	(Being the amount of loan taken from bank for payment to Preference Shareholders)			
	Preference Shareholders A/c	Dr.	99,000	
	To Bank A/c			99,000
	(Being the amount paid to Preference Shareholders for redmeption of 900 shares @ ₹ 110 each)			

Balance Sheet of Green Ltd. as at 1st April, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,30,000
(b) Reserves and Surplus	(2)	1,16,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	50,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings	(4)	1,05,000
(b) Trade Payables		—
(c) Other Current Liabilities	(5)	15,000
(d) Short-term Provisions		—

Particulars	Note No.	Amount (₹)
TOTAL		5,16,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		4,00,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		50,000
(c) Trade Receivables		40,000
(d) Cash and Cash Equivalents		26,000
TOTAL		5,16,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
? Equity Shares of ? each		?
Issued, Subscribed and Paid-up Capital :		
4,000 Equity Shares of ₹ 10 each fully paid		40,000
20,000 Equity Shares of ₹ 10 each	2,00,000	
Less: Calls-in-Arrear (2 x 5,000)	10,000	1,90,000
		2,30,000

(2) Reserve and Surplus

Particulars		₹
Investment Allowance Reserve	40,000	
Development Rebate Reserve	10,000	
Capital Redemption Reserve	60,000	
Workmen Compensation Fund	6,000	1,16,000

(3) Long-Term Borrowings

10% Debentures	50,000

(4) Short-term Borrowings

Bank Loan	25,000
Other Unsecured Loans	80,000
	1,05,000

(5) Other Current Liabilities

Amount due to Preference Shareholders	11,000
Workmen Compensation Payable	4,000
	15,000

Working Notes :

(1) Calculation of Bank Loan to be Taken

	₹
Bank balance at present	10,000
Add: Issue of equity shares	40,000
Issue of 10% Debentures	50,000
	1,00,000
Less: Balance to be maintained in the bank	26,000
Amount available for payment to preference shareholders	74,000
Amount required for payment to preference shareholders	99,000
Less: Amount available	74,000
Bank Loan to be taken	25,000

(2) Amount to be transferred to Capital Redemption Reserve

	₹
Face value of shares redeemed	1,00,000
Less: Proceeds from fresh issue	40,000
Amount to be transferred to Capital Redemption Reserve	60,000

(3) Dividend equalisation fund, development rebate reserves are free reserves. It can be unutilised for the purpose of creation of CRR.

Illustration 10

The financial position of P Limited at 31st December, 2016 was as follows :

Balance Sheet of P Ltd. as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,00,000
(b) Reserves and Surplus	(2)	3,30,000
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		60,000
(b) Trade Payables		1,00,000
(c) Other Current Liabilities		50,000
TOTAL		11,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		6,00,000
(2) Current Assets :		
(a) Current Investments		40,000
(b) Inventories		1,00,000
(c) Trade Receivables		1,00,000
(d) Cash and Cash Equivalents		3,00,000
TOTAL		11,40,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
25,000 Equity Shares of ₹ 10 each	2,50,000
40,000, 5% Preference Shares of ₹ 10 each	4,00,000
	6,50,000
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000
40,000, 5% Redeemable Preference Shares of ₹ 10 each fully paid	4,00,000
	6,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	50,000
Profit and Loss Account	2,80,000
	3,30,000

As per the terms of issue of the Preference Shares these were redeemable at a premium of 5 percent on 1st February, 2017 and it was decided to arrange this as far as possible out of the company's resources subject to leaving a balance of ₹ 50,000 in the credit of the Profit and Loss Account. It was also decided to raise the balance amount of issue of 17,000 equity shares of ₹ 10 each at a premium of ₹ 2.50 per share.

You are required to prepare the necessary Ledger Accounts giving effect to the above arrangements in the company's books. Journal Entries are not required.

Solution

Ledger of P Limited

Dr. 5% Redeemable Preference Share Capital Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2017 Feb 1	To Preference Shareholders A/c	4,00,000	2017 Jan 1	By Balance b/d	4,00,000

Dr. Preference Shareholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2017 Feb 1	To Bank A/c	4,20,000	2017 Feb 1	By 5% Redeemable Pre. Share Capital A/c	4,00,000
				By Premium on Redemption of Pref. Shares A/c	20,000
		4,20,000			4,20,000

Dr. Premium on Redemption of Preference Shares Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2017 Feb 1	To Preference Shareholders A/c	20,000	2017 Feb 1	By Profit and Loss A/c (T.N. 2)	20,000

Dr. Equity Shares Application and Allotment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2017 Feb 1	To Equity Share Capital A/c	1,70,000	2017 Feb 1	By Bank A/c	2,12,500
"	To Securities Premium A/c	42,500			
		2,12,500			2,12,500

Dr. **Equity Share Capital Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Feb 1	To Balance c/d	3,70,000	Jan 1	By Balance b/d	2,00,000
			Feb 1	By Equity Share Application and Allotment A/c	1,70,000
		3,70,000			3,70,000

Dr. **Capital Redemption Reserve Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Feb 1	To Balance c/d	2,30,000	Feb 1	By Profit and Loss A/c	2,30,000

Dr. **Cash and Bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Feb 1	To Balance b/d	3,00,000	Feb 1	By Preference Shareholders A/c	4,20,000
	To Equity Share Application and Allotment A/c	2,12,500		By Balance c/d	92,500
		5,12,500			5,12,500

Dr. **Securities Premium Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Feb 1	To Balance c/d	92,500	Jan 1	By Balance b/d	50,000
			Feb 1	By Equity Share Application and Allotment A/c	42,500
		92,500			92,500

Dr. **Profit and Loss Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2017			2017		
Feb 1	To Premium on Redemption of Pref. Share	20,000	Jan 1	By Balance b/d	2,80,000
	To Capital Redemption Reserve A/c	2,30,000			
"	To Balance c/d	30,000			
		2,80,000			2,80,000

Tutorial Note :

(1) No dividend has been paid on preference shares for one month.

(2) As per the provision of Section 55(2)(d) of the Companies Act, 2013 premium payable on redemption of preference shares should be paid ***out of profit.***

Illustration 11

The Balance Sheet of XYZ Ltd. as at 31st December, 2016, *inter alia*, includes the following :

	₹
50,000, 8% Preference Share of ₹ 100 each, ₹ 70 paid-up	35,00,000
1,00,000, Equity Shares of ₹ 100 each fully paid-up	1,00,00,000
Profit and Loss Account	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000

Under the terms of their issue, the preference shares are redeemable on March 31, 2017 at a premium of 5%. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹ 100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) on allotment and the balance on January 1, 2017. The issue was fully subscribed and allotment made on March 1, 2017. The monies due on allotment were received by March 30, 2017.

The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013. The company decided to make the minimum utilisation of general reserve.

You are asked to pass the necessary Journal Entries and show the relevant extract of the Balance Sheet after redemption.

Solution

As per the provision of Section 55(2) of the Companies Act, 2013, **No such shares shall be redeemed unless they are fully paid**. Under the terms of issue, 50,000, 8% Preference shares are to be redeemed on 31st March, 2017. For the purpose of redemption of these 50,000 shares, all shares are to be converted into fully paid shares by calling ₹ 30 per share.

In the books of XYZ Ltd
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017	Preference Share Final Call A/c	Dr.	15,00,000	
?	To 8% Preference Share Capital A/c			15,00,000
	(Being final call money due on 50,000 shares @ ₹ 30 each as per Board's Resolution No. . . . dated . . .)			
?	Bank A/c	Dr.	15,00,000	
	To Preference Share Final Call A/c			15,00,000
	(Being final call money received on 50,000 shares @ ₹ 30 each)			
?	Bank A/c	Dr.	10,00,000	
	To Equity Share Application A/c			10,00,000
	(Being application received for 50,000 equity shares @ ₹ 20 each)			
Mar 1	Equity Share Application A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			10,00,000
	(Being application money transferred to Equity Share Capital Account on 50,000 shares @ ₹ 20 each as per Board's Resolution No. . . . dated . . .)			
"	Equity Share Allotment A/c	Dr.	17,50,000	
	To Securities Premium A/c			5,00,000
	To Equity Share Capital A/c			12,50,000
	(Being allotment money due on 50,000 shares @ ₹ 35 each including premium of ₹ 10 each as per Board's Resolution No. ... dated. ...)			
Mar 30	Bank A/c	Dr.	17,50,000	
	To Equity Share Allotment A/c			17,50,000
	(Being allotment money received on 50,000 shares @ ₹ 35 each)			
Mar 31	8% Preference Share Capital A/c	Dr.	50,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	2,50,000	
	To Preference Shareholders A/c			52,50,000
	(Being the amount payable on redemption of 50,000 preference shares transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	52,50,000	
	To Bank A/c			52,50,000
	(Being the amount paid on redemption of preference shares)			
	Profit and Loss A/c	Dr.	2,50,000	
	To Premium on Redemption of Preference Shares A/c			2,50,000
	(Being the premium payable on redemption adjusted against Profit and Loss Account)			
	General Reserve A/c	Dr.	27,50,000	
	To Capital Redemption Reserve A/c			27,50,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Balance Sheet of XYZ Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹ '000)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,250
(b) Reserves and Surplus	(2)	7,750
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment		—
(3) Non-current Liabilities		—
(4) Current Liabilities		—
TOTAL		

Notes to Accounts :

(1) Share Capital

Particulars	₹ '000
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,000
50,000 Equity Shares of ₹ 100 each, ₹ 45 called-up and paid-up	2,250
	12,250

(2) Reserve and Surplus

Particulars	₹ '000
Capital Redemption Reserve (Note 2)	4,750
Securities Premium Account (Note 4)	500
Profit and Loss Balance	250
General Reserve (Note 3)	2,250
	7,750

Working Notes :

(1) Amount to be Transferred to Capital Redemption Reserve Account

Particulars	₹
Face value of shares redeemed (50,000 x ₹ 100)	50,00,000
Less: Proceeds from fresh issue (50,000 x ₹ (20 + 25)	22,50,000
Transferred from General Reserve	27,50,000

(2) Balance of Capital Redemption Reserve as on 31.3.2017	₹
Balance as on 31.12.2016	20,00,000
Add: Transferred from General Reserve	27,50,000
	47,50,000

(3) Balance of General Reserve as on 31.3.2017	₹
Balance as on 31.12.2016	50,00,000
Less: Transferred to Capital Redemption Reserve	27,50,000
	22,50,000

(4) Balance of Securities Premium as on 31.3.2017	₹
Balance as on 31.12.2016	—
Add: Amount received from new issue (50,000 x ₹ 10)	5,00,000
	5,00,000

(5) Change in Balance of Cash and Bank	₹
Receipts :	
Final call money of preference shares (50,000 x ₹ 30)	15,00,000
Application money of equity shares (50,000 x ₹ 20)	10,00,000
Allotment money of equity shares (50,000 x ₹ 35)	17,50,000
	42,50,000
Payments :	
Amount paid to preference shareholders	52,50,000
	(10,00,000)

Illustration 12

The capital structure of a company consists of 20,000 Equity Shares of ₹ 10 each fully paid up and 1,000 8% Redeemable Preference Shares of ₹ 100 each fully paid up.

Undistributed reserve and surplus stood as: General Reserve ₹ 80,000; Profit and Loss Account ₹ 10,000; Investment Allowance Reserve (out of which ₹ 5000, not free for distribution as dividend) ₹ 10,000; Securities Premium ₹ 12,000. Cash at bank amounted to ₹ 98,000. Preference Shares are to be redeemed at a premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilising the undistributed reserve and surplus, subject to the condition that a sum of ₹ 10,000 shall be retained in general reserve and which should not be utilised.

Pass Journal Entries to give effect to the above arrangements and also show the extract of the Balance Sheet of the company after the redemption carried out.

[I.C.W.A. (Inter) — Adapted]

Solution

In the books of ...
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	25,000	
	To Equity Shares Application A/c			25,000
	(Being application money received for 2,500 equity shares @ ₹ 10 each)			
	Equity Shares Application A/c	Dr.	25,000	
	To Equity Share Capital A/c			25,000
	(Being the issue of 2,500 Equity Shares of ₹ 10 each per share as per Board's Resolution No.... dated...)			
	8% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	10,000	
	To Preference Shareholders A/c			1,10,000
	(Being the the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	1,10,000	
	To Bank A/c			1,10,000
	(Being the amount paid on redemption of preference shares)			

	Profit and Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being the premium payable on redemption provided out of Profit and Loss Account)		10,000	10,000
	General Reserve A/c Dr. Investment Allowance Reserve A/c Dr. To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)		70,000 5,000	75,000

Balance Sheet as at ... [Extract]

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,25,000
(b) Reserves and Surplus	(2)	1,02,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment		—
(3) Non-current Liabilities		—
(4) Current Liabilities		—
TOTAL		

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
22,500 Equity Shares of ₹ 10 each fully paid	2,25,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	10,000
Securities Premium	12,000
Capital Redemption Reserve	75,000
Investment Allowance Reserve	5,000
	1,02,000

Working Note :

(1) No. of Shares to be Issued for Redemption of Preference Shares :

Face value of shares redeemed		₹ 1,00,000
Less: Profit available for distribution as dividend :		
General reserve : ₹ (80,000 – 10,000)	₹ 70,000	
Investment allowance reserve : ₹ (10,000 – 5,000)	₹ 5,000	₹ 75,000
		₹ 25,000

Illustration 13

The following is the Balance Sheet of Srabanti Company Limited as on 31.12.2016 :

Balance Sheet of Srabanti Company Limited as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	15,00,000
(b) Reserves and Surplus	(2)	10,50,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings – Unsecured		50,000
(b) Trade Payables		2,00,000
(c) Other Current Liabilities		1,00,000
TOTAL		29,00,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	15,00,000
(2) Current Assets :		
(a) Current Investments		3,00,000
(b) Inventories		4,70,000
(c) Trade Receivables	(4)	4,00,000
(d) Cash and Cash Equivalents	(5)	2,30,000
TOTAL		29,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
2,00,000 Equity Shares of ₹ 10 each	20,00,000
5,000 Redeemable Preference Shares of ₹ 100 each	5,00,000
	25,00,000
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each	10,00,000
5,000, 7.5% Redeemable Preference Shares of ₹ 100 each	5,00,000
	15,00,000

(2) Reserve and Surplus

Securities Premium	1,00,000
General Reserve	7,50,000
Profit and Loss Account	2,00,000
	10,50,000

(3) Tangible Assets

Particulars	₹
Land and Building	8,00,000
Plant and Machinery	6,00,000
Furniture and Fittings	1,00,000
	15,00,000

(4) Trade Receivables

Trade Debtors	2,00,000
Bills Receivables	2,00,000
	4,00,000

(6) Cash and Cash Equivalents

Cash at Bank	1,75,000
Cash in Hand	55,000
	2,30,000

On 1st January, 2017, it was decided to redeem all the preference shares at a premium of 5%. To finance the redemption, all the investments were sold for ₹ 2,80,000. The company issued 10,000 equity shares of ₹ 10 each at par and 1,000, 6% debentures of ₹ 100 each at par.

On 1.2.2017, the company made a bonus issue of 1 equity share of ₹ 10 each for every 2 shares held on that date. It was also decided to use General Reserve as minimum as possible.

Draft the Journal Entries including Cash Book entries to give effect to the above decisions and also prepare a Balance Sheet.

Solution **In the books of Srabanti Company Limited**

Journal **Dr.** **Cr.**

Date	Particulars		₹	₹
2017 Jan. 1	Bank A/c	Dr.	2,80,000	
	Profit & Loss A/c	Dr.	20,000	
	To Investments A/c			3,00,000
	(Being the sale of investments for ₹ 2,80,000, loss debited to Profit & Loss Account)			
	Bank A/c	Dr.	1,00,000	
	To Equity Share Application A/c			1,00,000
	(Being application money received on 10,000 equity shares @ ₹ 10 each)			
	Equity Shares Application A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Being the issue of 10,000 equity shares of ₹ 10 each at par per share as per Board's Resolution No. ...)			
	Bank A/c	Dr.	1,00,000	
	To Debenture Application A/c			1,00,000
	(Being application money received on 1,000 Debentures @ ₹ 100 each)			
	Debenture Application A/c	Dr.	1,00,000	
	To 6% Debentures A/c			1,00,000
	(Being the issue of 1,000, 6% debentures of ₹ 100 each at par as per Boards' Resolution No. ... dated ...)			
	7.5% Redeemable Preference Share Capital A/c	Dr.	5,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	25,000	
	To Preference Shareholders A/c			5,25,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			

			Dr. (₹)	Cr. (₹)
	Preference Shareholders A/c	Dr.	5,25,000	
	To Bank A/c			5,25,000
	(Being the preference shareholders paid-off on redemption)			
	General Reserve A/c	Dr.	4,00,000	
	To Capital Redemption Reserve A/c (Note 1)			4,00,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	Profit and Loss A/c	Dr.	25,000	
	To Premium on Redemption of Preference Shares A/c			25,000
	(Being the premium on redemption of Preference Shares Account adjusted against Profit and Loss Account)			
Feb. 1	Capital Redemption Reserve A/c	Dr.	4,00,000	
	Securities Premium A/c	Dr.	1,00,000	
	To Bonus to Shareholders A/c			5,00,000
	(Being bonus dividend payable to shareholders in the ratio of 2 : 1 as per Shareholders' Resolution No... dated...)			
	Bonus to Shareholders A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			5,00,000
	(Being the utilisation of bonus dividend towards the issue of 50,000 equity shares of ₹ 10 each at par as per Board's Resolution No. ... dated ...)			

Balance Sheet of Srabanti Company Limited as at 1st February, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	16,00,000
(b) Reserves and Surplus	(2)	5,05,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	1,00,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(5) Current Liabilities :		—
(a) Short-term Borrowings		50,000
(b) Trade Payables		2,00,000
(c) Other Current Liabilities		1,00,000
(d) Short-term Provisions		—
TOTAL		25,55,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	15,00,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		4,70,000
(c) Trade Receivables	(5)	4,00,000
(d) Cash and Cash Equivalents	(6)	1,85,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		25,55,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
2,00,000 Equity Shares of 10 each	20,00,000
5,000, 7.5% Redeemable Pref. Shares of ₹ 100 each	5,00,000
	25,00,000
Issued, Subscribed and Paid-up Capital :	
1,60,000 Equity Shares of ₹ 10 each fully paid	16,00,000
(Including 50,000 bonus shares)	
(2) Reserve and Surplus	
General Reserve (7,50,000 – 4,00,000)	3,50,000
Profit and Loss Account (2,00,000 – 20,000 – 25,000)	1,55,000
	5,05,000
(3) Secured Loans	
1,000, 6% Debentures of ₹ 100 each	1,00,000

(4) Fixed Assets

Particulars	₹
Land and Building	8,00,000
Plant and Machinery	6,00,000
Furniture and Fittings	1,00,000
	15,00,000
(5) Trade Receivables	
Trade Debtors	2,00,000
Bills Receivables	2,00,000
	4,00,000
(6) Cash and Cash Equivalents	
Cash at Bank (1,75,000 + 2,80,000 + 2,00,000 – 5,25,000)	1,30,000
Cash in Hand	55,000
	1,85,000

Working Notes : (1) Amount to be Transferred to Capital Redemption Reserve Account

	₹
Face value of shares to be redeemed	5,00,000
Less: Proceeds from fresh issue (10,000 x ₹ 10)	1,00,000
	4,00,000

(2) Proceeds from issue of debentures cannot be used for redemption of preference shares.
(3) It is assumed that new equity shareholders are not entitled to bonus shares.

Illustration 14

X Ltd has the following Balance Sheet as on 31.3.2017:

Balance Sheet of X Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	15,00,000
(b) Reserves and Surplus	(2)	5,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		5,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		5,00,000
TOTAL		30,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		22,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		4,00,000
(c) Trade Receivables		2,00,000
(d) Cash and Cash Equivalents		2,00,000
TOTAL		30,00,000

Notes to Accounts :

(1) Share Capital Particulars	₹	**(2) Reserve and Surplus** Particulars	₹
Authorised Capital :		Capital Reserve	1,00,000
20,000 Equity Shares of ₹ 100 each	20,00,000	Securities Premium	50,000
5,000 Redeemable Preference Shares of ₹ 100 each	5,00,000	General Reserve	2,00,000
	25,00,000	Profit and Loss Account	1,50,000
Issued, Subscribed and Paid-up Capital :			5,00,000
10,000 Equity Shares of ₹ 10 each	10,00,000	**(3) Fixed Assets**	
5,000, Redeemable Preference Shares of ₹ 100 each	5,00,000	(i) *Tangible Assets*	
	15,00,000	Land and Building	12,00,000
		Plant and Machinery	10,00,000
			22,00,000

The Preference Shares are to be redeemed at 10% premium. Fresh issue of equity shares is to be made to the extent it is required under the Companies Act for the purpose of this redemption. The shortfall in funds for the purpose of the redemption after utilising the proceeds of the fresh issue are to be met by taking a bank loan. Show Journal Entries.

Solution

In the books of X Limited

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c Dr.	2,00,000	
	To Equity Share Application A/c (Note 1)		2,00,000
	(Being application money received on 2,000 equity shares @ ₹ 100 each)		
	Equity Share Application A/c Dr.	2,00,000	
	To Equity Share Capital A/c (Note 1)		2,00,000
	(Being the issue of 2,000 Equity shares of ₹ 100 each, for redemption of preference shares, as per Board's Resolution No... dated ...)		
	General Reserve A/c Dr.	2,00,000	
	Profit & Loss A/c (₹ 1,50,000 – ₹ 50,000)	Dr1,00,000	
	To Capital Redemption Reserve A/c		3,00,000
	(Being the amount transferred to Capital Redemption Reserve)		
	Redeemable Preference Share Capital A/c Dr.	5,00,000	
	Premium on Redemption of Preference Shares A/c Dr.	50,000	
	To Preference Shareholders A/c		5,50,000
	(Being the amount payable on redemption of preference shares transferred to Shareholders Account)		
	Bank A/c (Note 2) Dr.	3,50,000	
	To Bank Loan A/c		3,50,000
	(Being the necessary amount taken from bank as loan for redeeming the preference shares)		
	Redeemable Preference Shareholders A/c Dr.	5,50,000	
	To Bank A/c		5,50,000
	(Being the preference shareholders paid-off on redemption)		
	Profit and Loss A/c Dr.	50,000	
	To Premium on Redemption of Preference Shares A/c		50,000
	(Being the premium payable on redemption adjusted against Profit and Loss Account)		

Working Notes :

(1) Calculation of No. of Shares to be Issued

Face Value of Shares redeemed	₹ 5,00,000
Less : Profits available for dividend (₹ 2,00,000 + ₹ 1,00,000)	₹ 3,00,000
Proceeds required from new issue	₹ 2,00,000

Therefore, No. of shares to be issued ₹ 2,00,000/ ₹ 100 = 2,000.

(2) Amount required for payment to preference shareholders = ₹ 5,50,000. Amount received by issuing equity share is ₹ 2,00,000. Therefore, ₹ 3,50,000 is to be taken from bank as loan.

Illustration 15

The following is the Balance Sheet of H Limited as on June 30, 2017 :

Balance Sheet of H Limited as at 30th June, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	90,000
(b) Reserves and Surplus	(2)	93,500
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		19,500
TOTAL		2,03,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		1,00,000
(2) Current Assets :		
(a) Current Investments		21,000
(b) Inventories		44,000
(c) Trade Receivables		16,000
(d) Cash and Cash Equivalents		22,000
TOTAL		2,03,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 100 each	1,00,000
3,000, 6%Redeemable Preference Shares of ₹ 10 each	30,000
	1,30,000
Issued, Subscribed and Paid-up Capital :	
6,000 Equity Shares of ₹ 10 each	60,000
3,000, 6% Redeemable Preference Shares of ₹ 10 each fully paid up	30,000
	90,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	29,000
General Reserve	40,000
Profit and Loss Account	24,500
	93,500

The Company exercised its option to redeem, on July 1, 2017, the whole of the preference shares at a premium of 5%.

To assist in financing the redemption, all the investments were sold, realising ₹ 19,500.

On September 1, 2017, the Company made a bonus issue of one equity share fully paid for every six equity shares held on that date.

The appropriate resolutions having been passed, the above transactions were duly completed.

You are required to show the Journal Entries to record the transactions in the books of the company and the Balance Sheet as it would appear after the completion of the transactions.

Solution

In the books of H Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 July 1	Bank A/c	Dr.	19,500	
	Profit & Loss A/c	Dr.	1,500	
	To Investments A/c			21,000
	(Being the sale of investments for ₹ 19,500, loss debited to Profit & Loss Account)			

	6% Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To Preference Shareholders A/c (Being the amount payable on redemption transferred to Shareholders' Account as per Board's Resolution No. ... dated ...)		30,000 1,500	 31,500
	Preference Shareholders A/c Dr. To Bank A/c (Being the amount paid on redemption of preference shares)		31,500	 31,500
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)		30,000	 30,000
	Profit and Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being premium payable on redemption of preference shares adjusted against Profit and Loss Account)		1,500	 1,500
Sept. 1	Capital Redemption Reserve A/c Dr. To Bonus to Equity Shareholders A/c (Being the amount appropriated for issue of 1,000 Equity shares of ₹ 10 each fully paid as per Shareholders Resolution No. ... dated ...)		10,000	 10,000
	Bonus to Equity Shareholders A/c Dr. To Equity Share Capital A/c (Being the utilisation of Bonus dividend for issuing Equity shares)		10,000	 10,000

Balance Sheet of H Ltd. as at 1st September, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	70,000
(b) Reserves and Surplus	(2)	80,500
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Long-term Provisions		—
(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		19,500
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		1,70,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		1,00,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		44,000
(c) Trade Receivables		16,000
(d) Cash and Cash Equivalents		10,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		1,70,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of 10 each	1,00,000
3,000, 6% Redeemable Preference Shares of ₹ 10 each	30,000
	1,30,000
Issued, Subscribed and Paid-up Capital :	
7,000 Equity Shares of ₹ 10 each fully paid	70,000
(Of the above, 1,000 shares have been issued as bonus shares)	

(2) Reserve and Surplus

Particulars	₹
Capital Redemption Reserve	20,000
Securities Premium	29,000
General Reserve	10,000
Profit and Loss Account	21,500
	80,500

Illustration 16

Rao Galvanising Co. Ltd had an authorised equity capital of ₹ 20 lakhs divided into shares of ₹ 100 each. The paid-up capital was ₹ 12,50,000. Besides this, the company had 9% Redeemable Cumulative Preference Shares of ₹ 10 each for ₹ 2,50,000. Balances on other accounts were: Securities Premium — ₹ 28,000; Profit and Loss Account — ₹ 72,000 and General Reserve — ₹ 3,40,000. Included in Sundry Assets were investments of the face value of ₹ 30,000 carried in the books at a cost of ₹ 34,000.

The company decided to redeem the Cumulative Preference Shares at 10% premium, partly by the issue of equity shares of the face value of ₹ 1,20,000 at a premium of 10%. Investments were sold at 105% of their face value. All preference shareholders were paid off except 3 holders holding 250 shares.

After redemption of the Cumulative Preference Shares, fully paid bonus shares were issued in the ratio of 4 : 1.

Give the necessary Journal Entries bearing in mind that the Directors wanted a minimum reduction in free reserves, while effecting the above transactions. Working should form part of your answer.

Solution

In the books of Rao Galvanising Company Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c (Note 2)	Dr.	31,500	
	Profit & Loss A/c	Dr.	2,500	
	To Investment A/c			34,000
	(Being the sale of investment for ₹ 31,500, loss debited to Profit & Loss Account)			
	Bank A/c	Dr.	1,32,000	
	To Equity Share Application A/c			1,32,000
	(Being application money received on 1,200 equity shares @ ₹ 110 each)			
	Equity Share Application A/c	Dr.	1,32,000	
	To Equity Share Capital A/c			1,20,000
	To Securities Premium A/c			12,000
	(Being issue of 1,200 equity sh. of ₹ 100 each fully paid at a premium of 10% as per Board's Resolution No ..dt....)			
	9% Redeemable Cumulative Preference Share Capital A/c	Dr.	2,50,000	
	Premium on Redemption of Preference Shares A/c	Dr.	25,000	
	To Preference Shareholders A/c			2,75,000
	(Being the amount payable on redemption transferred to Shareholders A/c as per Board's Resolution No. ...dt ...)			
	Preference Shareholders A/c	Dr.	2,72,250	
	To Bank A/c			2,72,250
	(Being the amount payable to preference shareholders holding 24,750 shares)			
	General Reserve A/c (Note 1)	Dr.	1,30,000	
	To Capital Redemption Reserve A/c			1,30,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	Profit and Loss A/c	Dr.	25,000	
	To Premium on Redemption of Preference Shares A/c			25,000
	(Being premium payable on redemption of preference shares charged to Profit and Loss Account)			
	Capital Redemption Reserve A/c	Dr.	1,30,000	
	Securities Premium A/c : ₹ (28,000 + 12,000)	Dr.	40,000	
	General Reserve A/c	Dr.	1,72,500	
	To Bonus to Equity Shareholders A/c			3,42,500
	(Being the bonus dividend payable in the ratio of 4 : 1 to the holders of 13,700 shares as per Shareholders Resolution No. ... dated ...)			
	Bonus to Equity Shareholders A/c	Dr.	3,42,500	
	To Equity Share Capital A/c			3,42,500
	(Being the issue of bonus shares to existing shareholders in the ratio of 4 : 1)			

Working Notes : (1) Amount to be Transferred to Capital Redemption Reserve Account :

Face value of shares to be redeemed	₹ 2,50,000
Face value of shares newly issued(excluding premium)	₹ 1,20,000
	₹ 1,30,000

(2) Amount received by sale of investment = ₹ 30,000 / 100 x 105 = ₹ 31,500.

Illustration 17

The following is the Summarised Balance Sheet of Redeemable Limited :

Balance Sheet of Redeemable Limited as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,99,000
(b) Reserves and Surplus	(2)	1,50,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		1,51,000
TOTAL		9,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		8,10,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		90,000
TOTAL		9,00,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
? Equity Shares of ? each		?
Issued, Subscribed and Paid-up Capital :		
50,000 Equity Shares of ₹ 10 each		5,00,000
1,000, 10% Redeemable Preference Shares of ₹ 100 each	1,00,000	
Less: Calls-in-arrear @ ₹ 20 each	1,000	99,000
		5,99,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	20,000
Profit and Loss Account	60,000
General Reserve	70,000
	1,50,000

The redeemable preference shares were redeemed on 1st April, 2017 on the following basis:

1. Further 4,500 equity shares were issued at a premium of 10%;
2. Expenses for fresh issue of shares ₹ 5,000;
3. Of the 50 preference shares, holders of 40 shares paid the call money before the date of redemption. The balance 10 shares were forfeited for non-payment of calls before redemption. The forfeited shares were re-issued as fully paid on receipt of ₹ 500 before redemption;
4. Preference shares were redeemed at a premium of 10% and securities premium account was utilised in full for this purpose.

Show Journal Entries including those relating to cash and the summarised Balance Sheet after redemption.

Solution

In the books of Redeemable Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 Apr 1	Bank A/c	Dr.	800	
	To Calls-in-Arrear A/c			800
	(Being money received on 40 shares @ ₹ 20 each in respect of calls-in-arrear)			
	10% Redeemable Preference Share Capital A/c	Dr.	1,000	
	To Calls-in-Arrear A/c			200
	To Forfeited Shares A/c			800
	(Being forfeiture of 10 shares for non payment of calls as per Board's Resolution No ... dated ...)			
	Bank A/c	Dr.	500	
	Forfeited Shares A/c	Dr.	500	
	To 10% Redeemable Preference Share Capital A/c			1,000
	(Being the re-issue of 10 shares @ ₹ 50 each as fully paid as per Board's Resolution No. ... dated ...)			
	Forfeited Shares A/c	Dr.	300	
	To Capital Reserve A/c			300
	(Being profit on re-issue transferred to Capital Reserve Account)			
	Bank A/c	Dr.	49,500	
	To Equity Share Application A/c			49,500
	(Being application money received on 4,500 equity shares @ ₹ 11 each)			
	Equity Share Application A/c	Dr.	49,500	
	To Equity Share Capital A/c			45,000
	To Securities Premium A/c			4,500
	(Being the issue of 4,500 shares of ₹ 10 each at a premium of 10% as per Board's Resolution No... dtd...)			
	Expenses on Issue of Shares A/c	Dr.	5,000	
	To Bank A/c			5,000
	(Being expenses incurred for fresh issue of shares)			
	Profit & Loss A/c	Dr.	5,000	
	To Expenses on Issue of Shares A/c			5,000
	(Being the expenses on fresh issue of shares charged to Profit and Loss Account)			
	10% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	10,000	
	To Preference Shareholders A/c			1,10,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	1,10,000	
	To Bank A/c			1,10,000
	(Being the amount paid on redemption)			
	General Reserve A/c	Dr.	55,000	
	To Capital Redemption Reserve A/c			55,000
	(Being the amount transferred to Capital Redemption Reserve as per the requirement of the Act)			
	Profit and Loss A/c	Dr.	10,000	
	To Premium on Redemption of Preference Shares A/c			10,000
	(Being premium on redemption charged to Profit and Loss Account)			

Balance Sheet of Redeemable Limited as at1st April, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,45,000
(b) Reserves and Surplus	(2)	1,39,800
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—

(4) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		1,51,000
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		8,35,800
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		8,10,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		25,800
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		8,35,800

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital : 54,500 Equity Shares of ₹ 10 each fully paid	5,45,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	24,500
Profit and Loss Account	45,000
General Reserve	15,000
Capital Reserve	300
Capital Redemption Reserve	55,000
	1,39,800

Working Note : (1) Amount to be Transferred to Capital Redemption Reserve Account :

Face value of shares to be redeemed	₹ 1,00,000
Less : Proceeds from fresh issue (excluding premium)	₹ 45,000
	₹ 55,000

KEY POINTS

- No company limited by shares shall, after the commencement of this Act, issue any preference shares which are ***irredeemable***.
- ***Rule 10 of the Companies (Share Capital and Debentures) Rules, 2014*** states that a company engaged in the setting up and dealing with infrastructural projects may issue preference shares for a period exceeding twenty years but not exceeding thirty years, subject to the redemption of a minimum ten per cent of such preference shares per year from the twenty-first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.
- When preference shares are redeemed out of profit, an amount equal to nominal (face) value of the shares redeemed must be transferred to '***Capital Redemption Reserve***'. This Capital Redemption Reserve should be treated as paid-up share capital of the company.
- The premium payable on redemption must be adjusted against Profit and Loss Account.
- Both the resolution for redemption of preference shares and the issue of new shares are passed simultaneously.

THEORETICAL QUESTIONS

1. Discuss the provisions of the Companies Act, 2013 with regard to redemption of Redeemable Preference Shares.
2. Under what circumstances may a company issue Redeemable Preference Shares? Discuss the different methods of redemption of preference shares.
3. Discuss the provisions of Sec 55 of the Companies Act, 2013 with regard to redemption of irredeemable preference shares.
4. Discuss the logic behind the creation of capital redemption reserve.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Preference shares cannot be redeemed unless they are :
   A fully called up
   B fully paid up
   C issued at a premium
   D issued at par
2. Which of the following cannot be utilized for transferring to capital redemption reserve account ?
   A general reserve
   B profit and loss account balance
   C dividend equalization fund
   D securities premium
3. Which of the following cannot be utilized for the purpose of redemption of preference shares ?
   A proceeds from issue of equity shares
   B proceeds from issue of preference shares
   C proceeds from issue of rights shares
   D proceeds from issue of debentures
4. Proceeds in connection with issue of shares at a premium would mean :
   A face value of shares issued
   B face value of shares issued less expenses on issue of shares
   C face value of shares issued plus premium on issue of such shares
   D none of the above
5. Capital Redemption Reserve can only be used for issuing
   A rights shares
   B partly paid up bonus shares
   C preference shares
   D fully paid up bonus shares
6. Resolution for redemption of preference shares and the issue of new shares for this purpose are passed:
   A separately
   B simultaneously
   C within a week
   D after one week
7. Securities premium money out of fresh issue :
   A can be treated as proceeds
   B can be treated as revenue profit
   C cannot be treated as proceed
   D can be treated as proceeds under special circumstances
8. At present, a company can issue preference shares which is :
   A irredeemable
   B redeemable after the expiry of 20 years from the date of issue
   C redeemable before the expiry of 20 years from the date of issue
   D redeemable after the expiry of 25 years from the date of issue

9. Dividend on preference shares is paid :
   A at a variable rate
   B at a fixed rate / fixed amount
   C at par with equity shares
   D at par with debenture interest
10. A partly paid up preference share can be redeemed :
   A after the permission from Company Law Board
   B after making them fully paid up
   C after passing a special resolution
   D after the permission of board of directors

PRACTICAL QUESTIONS

1. The skeleton Balance Sheet of Happy Limited as at 31st March 2017 was as under :

	₹	₹
Liabilities :		
Share Capital : 18,000 — 9.5% Cum. Redeemable Pref. Shares of ₹ 100 each	18,00,000	
40,000 Equity Shares of ₹ 100 each	40,00,000	58,00,000
Reserve & Surplus : Securities premium	5,00,000	
General reserve	9,00,000	14,00,000
Secured Loan from Institutions		18,00,000
Current Liabilities and Provisions		16,00,000
		1,06,00,000

The Board of Directors decided to redeem the preference shares both by issue of fresh capital and by utilisation of Reserve but without any further borrowings. You are required to advice them the scheme for redemption and draw up the Balance Sheet after redemption along with journal entries. ***I.C.W.A. (Inter) — Adapted]***

2. Spotlight Ltd has issued share capital of 60,000—8% redeemable cumulative preference shares of ₹ 20 each and 4,00,000 equity shares of ₹ 10 each. The preference shares are redeemable at a premium of 5% on January 1, 2017. As on December 31, 2016 the company's Balance Sheet showed the following position :

Balance Sheet of Spotlight Ltd. as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	52,00,000
(b) Reserves and Surplus — Profit and Loss Account		7,00,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings		4,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		1,00,000
(b) Trade Payables		6,00,000
TOTAL		70,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(2)	34,00,000
(2) Current Assets :		
(a) Current Investments		3,50,000
(b) Inventories		15,00,000
(c) Trade Receivables		14,00,000
(d) Cash and Cash Equivalents		3,50,000
TOTAL		70,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
5,00,000 Equity Shares of ₹ 10 each	50,00,000
60,000, 8% Cumulative Preference Shares of ₹ 20 each	12,00,000
	62,00,000
Issued, Subscribed and Paid-up Capital :	
4,00,000 Equity Shares of ₹ 10 each	40,00,000
60,000, 8% Cumulative Shares of ₹ 20 each fully paid-up	12,00,000
	52,00,000

(2) Fixed Assets

Particulars	₹
(i) *Tangible Assets :*	
Plant and Machinery	25,00,000
Furniture and Fixtures	9,00,000
	34,00,000
	12,00,000

In order to facilitate the redemption of preference shares, it was decided:

(a) to sell the investments for ₹ 3,00,000;

(b) to finance part of the redemption from company funds subject to leaving of balance on Profit and Loss Account of ₹ 2,00,000;

(c) to issue sufficient equity shares of ₹ 10 each at a premium of ₹ 2 per share to raise the balance of funds required.

The preference shares were redeemed on the due date and equity shares were fully subscribed.

You are required to prepare :

(i) Journal Entries to record the above transactions; and

(ii) A Balance Sheet as on completion of redemption. ***[I.C.W.A. (Inter) — Adapted]***

3. The following is the summarised Balance Sheet of Cardamom Ltd as on 31st December, 2016.

Balance Sheet of Cardamom Ltd. as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,24,000
(b) Reserves and Surplus	(2)	68,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		28,000
TOTAL		3,20,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		2,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		50,000
(c) Trade Receivables		20,000
(d) Cash and Cash Equivalents		50,000
TOTAL		3,20,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
24,000 Equity Shares of ₹ 10 each	2,40,000
640, 8% Cumulative Preference Shares of ₹ 100 each	64,000
	3,04,000
Issued, Subscribed and Paid-up Capital :	
16,800 Equity Shares of ₹ 10 each	1,68,000
560, 8% Cumulative Shares of ₹ 100 each fully paid-up	56,000
	2,24,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	1,400
Profit and Loss Account	66,600
	68,000

The preference shares were redeemed on 1st January, 2017 at a premium of 10%. A bonus issue of 1 equity share for every 4 held was made on the same date. No trace could be found of the holders of 60 preference shares.

You are required to give the Journal Entries in the books of the Company and draw up the resultant Balance Sheet in a summarised form.

4. The Balance Sheet of Producers Ltd as at 31st December, 2016 is as follows :

Balance Sheet of Producers Ltd. as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,40,000
(b) Reserves and Surplus	(2)	55,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		30,000
TOTAL		2,25,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	1,32,000
(2) Current Assets :		
(a) Current Investments		28,000
(b) Inventories		30,000
(c) Trade Receivables		15,000
(d) Cash and Cash Equivalents		20,000
TOTAL		2,25,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 10 each	1,00,000
1,000, 9% Cumulative Preference Shares of ₹ 100 each	1,00,000
	2,00,000
Issued, Subscribed and Paid-up Capital :	
9,000 Equity Shares of ₹ 10 each	90,000
500, 9% Cumulative Shares of ₹ 100 each fully paid-up	50,000
	1,40,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	10,000
General Reserve	20,000
Profit and Loss Account	25,000
	55,000

(3) Fixed Assets

Particulars	₹
(i) *Tangible Assets :*	
Land and Building	1,00,000
Plant and Machinery	30,000
Furnitures	2,000
	1,32,000

The Company decided to redeem its preference shares at a premium of 5 per cent on 31st January 2017.

A fresh issue of 1,000 equity shares of ₹ 10 each was made at ₹ 12 per share, payable in full on 31st January, 2017. These were fully subscribed and all moneys were duly collected. All the investments were sold realising ₹ 27,000. The Directors wish that only a minimum reductions should be made in the revenue reserves.

You are required to give the journal entries, including those relating to cash to record the above transactions and draw up the Balance Sheet as it would appear after redemption of preference shares.

[I.C.W.A (Inter) — Adapted]

5. Exchange Limited has an issued Share Capital of 650 7% Redeemable Preference Shares of ₹ 100 each and 4,500 Equity Shares of ₹ 50 each. The Preference Shares are redeemable at a premium of 10% on April 1, 2017.
The Company's Balance Sheet as on March 31, 2017 was as follows :

Balance Sheet of Exchange Limited as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,90,000
(b) Reserves and Surplus — Profit and Loss		48,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		56,500
TOTAL		3,94,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,45,000
(2) Current Assets :		
(a) Current Investments		18,500
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		31,000
TOTAL		3,94,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
5,000 Equity Shares of ₹ 50 each	2,50,000
1,000, 7% Cumulative Preference Shares of ₹ 100 each	1,00,000
	3,50,000
Issued, Subscribed and Paid-up Capital :	
4,500 Equity Shares of ₹ 50 each	2,25,000
650, 7% Cumulative Shares of ₹ 100 each	65,000
	2,90,000

In order to facilitate the redemption of the Preference Shares, the Company decided :

(a) to sell all the investments for ₹ 16,000,

(b) to finance part of the redemption from company funds, subject to leaving a balance of ₹ 12,000 in the Profit and Loss Account, and

(c) to issue sufficient Equity Shares of ₹ 50 each at a premium of ₹ 13 per share to raise the balance of funds required.

The Preference Shares were redeemed on the due date and the issue of Equity Shares was fully subscribed.

You are required to prepare :

(i) the necessary Journal Entries to record the above transactions (including cash) and

(ii) the Balance Sheet as on completion. ***[C.A. (Inter) — Adapted]***

6. The books of S.B. Ltd showed the following balances on 31st December, 2016 :

30,000 Equity Shares of ₹ 10 each fully paid; 18,000 12% Redeemable Preference Shares of ₹ 10 each fully paid; 4,000 10% Redeemable Preference Shares of ₹ 10 each, ₹ 8 paid up.

Undistributed Reserve and Surplus stood as: Profit and Loss Account ₹ 80,000; General Reserve ₹ 1,20,000; Securities Premium Account ₹ 15,000 and Capital Reserve ₹ 21,000.

Preference shares are redeemed on 1st January, 2017 at a premium of ₹ 2 per share. The whereabouts of the holders of 100 shares of ₹ 10 each fully paid, are not known.

For redemption, 3,000 equity shares of ₹ 10 each are issued at 10% premium. At the same time, a bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital Redemption Reserve Account.

Show the necessary Journal Entries to record the transactions.

7. The Balance Sheet of Ananda Ltd as on 31st March, 2017 is given below :

Balance Sheet of Ananda Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,00,000
(b) Reserves and Surplus — Profit and Loss		1,60,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		1,20,000
TOTAL		9,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		4,00,000
(2) Current Assets :		
(a) Current Investments		2,00,000
(b) Inventories		1,00,000
(c) Trade Receivables		1,00,000
(d) Cash and Cash Equivalents		10,000
(6) Other Current Assets		1,70,000
TOTAL		9,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 100 each	10,00,000
20,000, 9% Cumulative Preference Shares of ₹ 100 each	2,00,000
	12,00,000
Issued, Subscribed and Paid-up Capital :	
5,000 Equity Shares of ₹ 100 each	5,00,000
20,000, 9% Cumulative Shares of ₹ 100 each	2,00,000
	7,00,000

On 1.4.2017 the Company—(a) redeemed the Preference Shares at a premium of ₹ 2 per share; (b) realised Investments at a value of ₹ 1,60,000; (c) issued at a premium of ₹ 40 per share, such a number of Equity Shares for the purpose of aforesaid redemption as to ensure that after the compliance with the requirements of the Companies Act, 2013, in regard to redemption of Preference Shares, the Credit Balance in Profit & Loss Account would be ₹ 25,000; (d) issued as bonus Equity Share at par at the rate of one share for every 20 shares held on 31st December, 2016 out of the said balance in Profit and Loss Account.

You are required to show : (a) necessary Journal Entries to record the above transactions (including cash); and (b) the Balance Sheet as on completion of the above transactions.

8. The financial position of R Limited at 31st March, 2017 was as follows :

Balance Sheet of R Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,00,000
(b) Reserves and Surplus	(2)	6,60,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		1,20,000
(b) Trade Payables		2,00,000
(c) Other Current Liabilities		1,00,000
TOTAL		22,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		12,00,000
(2) Current Assets :		
(a) Current Investments		80,000
(b) Inventories		2,00,000
(c) Trade Receivables		2,00,000
(d) Cash and Cash Equivalents		6,00,000
TOTAL		22,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
50,000 Equity Shares of ₹ 10 each	5,00,000
80,000, 5% Preference Shares of ₹ 10 each	8,00,000
	13,00,000
Issued, Subscribed and Paid-up Capital :	
40,000 Equity Shares of ₹ 10 each fully paid	4,00,000
80,000, 5% Redeemable Preference Shares of ₹ 10 each fully paid	8,00,000
	12,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	1,00,000
Profit and Loss Account	5,60,000
	6,60,000

As per the terms of issue of the Preference Shares these were redeemable at a premium of 5 per cent on 1st April, 2017 and it was decided to arrange this as far as possible out of the company's resources subject to leaving a balance of ₹ 1,00,000 in the credit of the Profit and Loss Account. It was also decided to raise the balance amount of issue of 34,000 equity shares of ₹ 10 each at a premium of ₹ 2.50 per share.

You are required to pass the necessary journal entries giving effect to the above arrangements in the company's books.

Guide to Answers

Multiple Choice

1. B; 2. D; 3. D; 4. A; 5. D; 6. B; 7. C; 8. C; 9. B; 10. B .

Practical Questions

1. **Amount to be transferred to Capital Redemption Reserve ₹ 9,00,000;**
   New issue of Shares ₹ 9,00,000.
2. **Profit and Loss Account ₹ 7,00,000 less loss on sale of investment ₹ 50,000 less premium paid on redemption ₹ 60,000 less balance to be kept ₹ 2,00,000.**
   Therefore balance left ₹ 3,90,000 for transferring to Capital Redemption Reserve.
   New issue 81,000 equity shares of ₹ 10 each.
   Balance Sheet equity Shares Capital ₹ 48,10,000;
   Profit and Loss Account ₹ 2,00,000.
   Share premium from new issue ₹ 1,62,000;
   Capital Redemption Reserve ₹ 3,90,000;
   Long-term Borrowings ₹ 4,00,000;
   Short-term Borrowings ₹ 1,00,000;
   Trade Payables ₹ 6,00,000;
   Total ₹ 66,62,000.
3. **Amount to be transferred to Capital Redemption Reserve ₹ 56,000;**
   Balance Sheet: Equity Share Capital ₹ 2,10,000;
   Share Premium ₹ 1,400;
   Capital Redemption Reserve ₹ 14,000;

Profit and Loss Account ₹ 5,000 Creditors ₹ 28,000;
Preference Shareholders ₹ 6,600;
Total ₹ 2,65,000.

4. **Amount to be transferred to Capital Redemption Reserve ₹ 40,000;**
   Balance Sheet: Equity Shares ₹ 1,00,000;
   Securities premium ₹ 12,000;
   Profit and Loss Account ₹ 1,500;
   Capital Redemption Reserve ₹ 40,000;
   Current Liabilities ₹ 30,000;
   Total ₹ 1,83,500.
5. **Profit and Loss Account ₹ 48,000; Less loss on sale of investment ₹ 2,500 Less premium paid on redemption ₹ 6,500 less balance to be kept ₹ 12,000.**
   Therefore, balance left ₹ 27,000 for transferring to Capital Redemption Reserve.
   New issue of 760 share of ₹ 50 each; Balance Sheet: Equity Shares ₹ 2,63,000;
   Profit & Loss ₹ 12,000;
   Capital Redemption Reserve ₹ 27,000;
   Share premium ₹ 9,880;
   Sundry Creditors ₹ 56,500;
   Total ₹ 3,68,380.
6. **Amount to be transferred to CRR : ₹ 1,50,000 (₹ 1,80,000 – ₹ 30,000).**
   Bonus was paid from CRR. Number of bonus shares issued is 12,000 @ ₹ 10 each.
7. **Balance Sheet total — ₹ 9,03,000. No. of shares to be issued — 1,450 of ₹ 100 each. Cash and Cash Equivalents — ₹ 1,33,000.**

6

Issue of Debentures

The Issue of Debentures

The capital structure of a company represents the long-term capital of the company which may consist of share capital as well as loan capital. Large and financially sound companies may obtain some long-term loans from financial institutions, like Industrial Development Bank of India, Life Insurance Corporation of India and so on. But to finance a large project, such as building a petro-chemical complex or purchasing a fleet of aeroplanes, a company may need more loan capital than what any single lender can provide. To arrange huge amounts of long-term loan capital perhaps ₹ 400 to ₹ 500 crore — a company issues debentures to the investing people, thus splitting a large loan into a great many units. When a company borrows money from investing people, it issues certificates which is stamped with the official seal of the company. These certificates are called "***Debentures***".

Debenture is the most common form of loan capital which is made available by investors on a long-term basis. It is a document containing details of an interest-bearing loan made to a company. Thus, a debenture is a document which evidences a loan. According to Section 2 (30) of the Companies Act 2013, debentures includes debenture stock, bonds and any other instruments of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

It is to be noted that the definition of '***debenture***' as per Section 2(12) of the Companies Act, 1956 was narrow. This section has defined debentured as 'debenture includes debenture stock, bonds and ***any other securities*** of a company, whether constituting a charge on the assets of the company or not'.

The phrase '***instrument of a company evidencing a debt***' used in the Companies Act, 2013 is much wider than the word '***securities***' used in Companies Act, 1956. As per the definition of the ***Companies Act, 2013*** debenture should include ***commercial paper*** and ***promissory note*** evidencing debt.

A predetermined fixed rate of interest is payable on debentures (whether the company has earned any profit or not). Debentureholders are the creditors of the company, not the owners. They have no voting rights and cannot influence the management for the affairs of the company, but their claims for interest and for repayment of principal rank ahead of the claims of the shareholders.

Features of a Debenture

1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security where interest falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.
4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.
7. It is a movable property .

Distinction between Debentures and Shares

	Debentures		**Shares**
1.	Debentureholders are the lenders of the company.	1.	Shareholders are the owners of the company.
2.	Debentureholders have no voting rights and consequently do not pose any threat to the existing control of the company.	2.	Shareholders have voting rights and consequently control the total affairs of the company.
3.	Debenture interest is paid at a pre-determined ***fixed*** rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3.	Dividend on equity shares is paid at a ***variable*** rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4.	Interests on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4.	Dividends are appropriation of profits and these are not deductible in determining taxable profit of the company.
5.	There are different kinds of debentures, such as Secured/ Unsecured; Redeemable/ Irredeemable; Convertible/ Non-convertible, etc.	5.	There are only two kinds of shares – Equity Shares and Preference Shares.
6.	In the Company Balance Sheet, Debentures are shown under "Long-term Borrowings".	6.	In the Company Balance Sheet, shares are shown under "Share Capital".
7.	Debentures can be converted into shares as per the terms of issue of debentures.	7.	Shares cannot be converted into debentures in any circumstances.
8.	The debentures cannot be forfeited for non-payment of calls money.	8.	Shares can be forfeited for non-payment of allotment and calls moneys.
9.	At maturity, debentureholders get back their money as per the terms and conditions of redemption.	9.	Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10.	At the time of liquidation, debentureholders are paid-off before the shareholders.	10.	At the time of liquidation shareholders are paid at last, after paying debentureholders, creditors, etc.

Advantages and Disadvantages of the Issue of Debentures

The main advantage of raising capital by issuing debentures, instead of shares, is that interest paid on debentures are deductible in determining taxable income of the company. Dividends paid to shareholders, however, are ***not deductible*** in computing taxable income of the company. Due to tax advantage, the cost of capital is lower in case of debenture financing.

To illustrate, X Ltd. issues 14% Debentures of ₹ 10,00,000. Income tax rate applicable to the company is 50%.

The effect on cost of capital is shown below :

Debenture interest p.a. (₹ 10,00,000 x 14%)	= ₹ 1,40,000
Less: Income tax savings (50% of ₹ 1,40,000)	= ₹ 70,000
After-tax cost of capital	= ₹ 70,000

Therefore, effective rate of borrowing = ₹ 70,000/10,00,000 x 100 = 7%.

If the rate of earnings is higher than the cost of debenture finance, the earnings of the equity shareholders will be increased. This is because, after meeting debenture interest (which is of a lower proportion), they will be entitled to the balance of earnings.

The main disadvantage of the issue of debentures is that if the interest payments account for too high a proportion of pre-tax earnings, then the company will not be able to pay the required rate of dividend to equity shareholders. The other disadvantage is that borrowing through debentures is usually done for a fixed time-span. Cash will be needed for the ultimate redemption of the debentures which may affect liquidity of the company.

Factors to be Considered for the Issue of Debentures

Whether a company will be able to raise further capital by the issue of debentures depends on the following factors:

From the viewpoint of the investors —

1. Past performance of the company and the quality of its management.
2. Future potential of the company, both in sales value and efficiency in controlling costs.
3. The availability of collateral security, either in fixed assets or current assets.
4. The borrowing capacity of the company as indicated by its debt/equity ratio.
5. The ability of the company to pay interest on debentures at fixed regular intervals and to redeem the debentures on the due date.

From the viewpoint of the company —

1. The required profits and cash available to pay debenture interest and to redeem debentures at some point in the future.
2. Borrowing power clauses in the Articles of Association.
3. The company's attitude towards capital gearing.
4. The availability of debenture finance.
5. The cost of debentures and the ability of the company to provide satisfactory return on equity share capital.

Types of Debentures

The following are the types of debentures issued by a company. They can be classified on the basis of : (1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.

1. Security

(a) Secured Debentures : These debentures are secured by a charge upon some or all assets of the company. There are two types of charges: (i) Fixed charge; and (ii) Floating charge. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debentureholders. The sale proceeds of these assets are utilised first for repaying debentureholders. A floating charge generally covers all the assets of the company including future one.

(b) Unsecured or "naked" Debentures : These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

It is very important to note that '***unsecured debentures***' will be treated as '***deposit***' and the Companies (Acceptance of Deposits) Rules, 2014 will be applicable.

2. Convertibility

(a) Convertible Debentures : These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debentureholders get a chance to become the shareholders of the company.

(b) Non-Convertible Debentures : These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

3. Permanence

(a) Redeemable Debentures : These debentures are repayable as per the terms of issue, for example, after 10 years from the date of issue.

(b) Irredeemable Debentures : These debentures are not repayable during the life time of the company. These are also called ***perpetual debentures***. These are repaid only at the time of liquidation.

In the Companies Act, 2013, there is no provision for issuing irredeemable debentures. As per Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 a company can issue only secured and redeemable debentures.

4. Negotiability

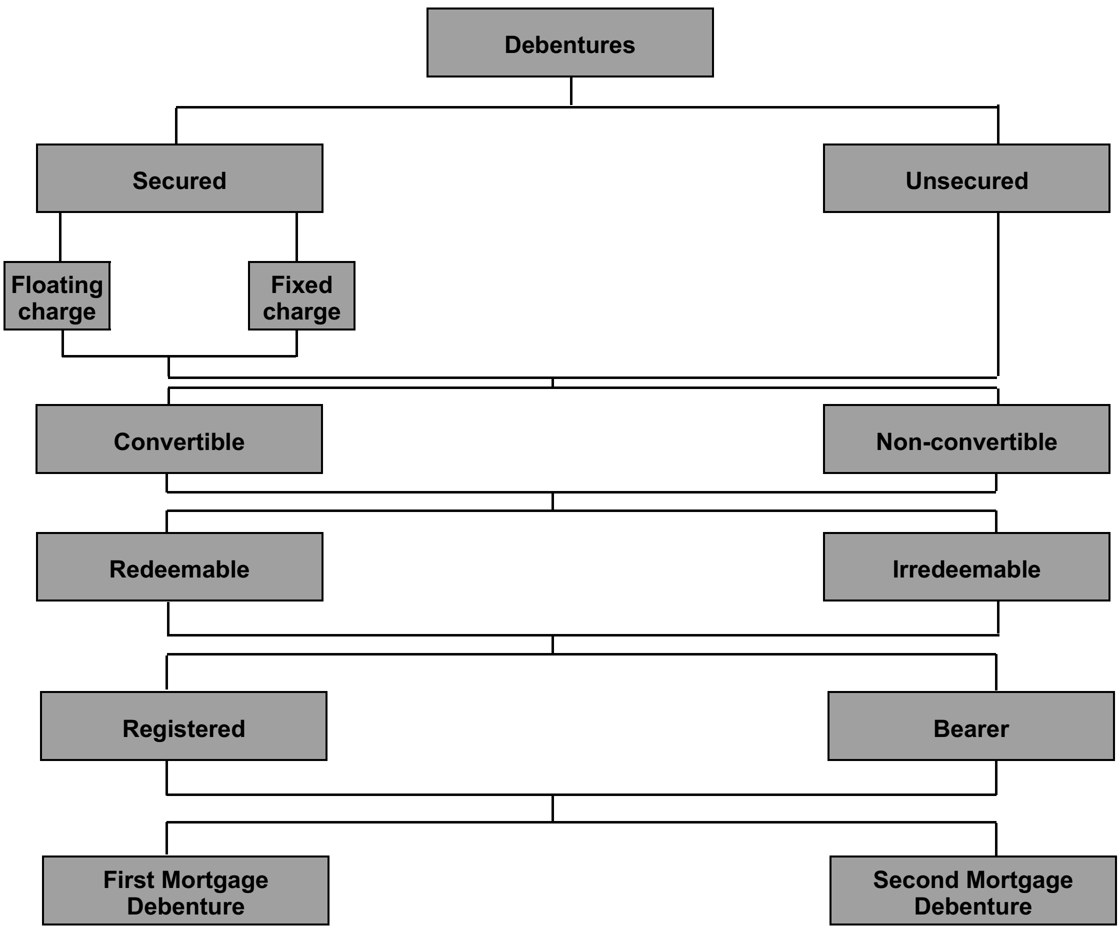
(a) Registered Debentures : These debentures are payable to a registered holder whose name, address and particulars of holding recorded in the Register of Debentureholders. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.

(b) Bearer Debentures : These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures.

5. Priority

(a) First Mortgage Debentures : These debentures are payable first out of the property charged.

(b) Second Mortgage Debentures : These debentures are payable after satisfying the first mortgage debentures.



Authorisation of a Debenture Issue

The memorandum of association must contain the provision for borrowing by the company. As per the provision of Section 179(3)(c),the Board of Directors of a company has the power to issue debentures on behalf of the company. However, a resolution of the Board of Directors is to be passed in this respect. After the Board of Directors has decided upon the details of debenture issue, the debenture certificates are printed and deed of trust is drawn. The trust deed contains the full details of the property to be mortgaged. The trustees are appointed to safeguard the interest of the debentureholders.

It is convenient to the company to make trustees parties to the deed instead of all the debentureholders. On the other hand, the debentureholders who are ignorant of law, can protect their rights and can bring an action against the company through trustees.

Issue of Debentures Under the Companies Act, 2013

A company ***may issue debentures*** after complying with the provisions of the Companies Act, 2013 and the Companies (Share Capital and Debentures) Rules 2014 and SEBI Regulations.

Section 71 of the Companies Act, 2013 states that :

(1) A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption:
Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by ***a special resolution*** passed at a general meeting.

(2) No company shall issue any debentures carrying any voting rights.

(3) Secured debentures may be issued by a company subject to such terms and conditions as may be prescribed.

(4) Where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.

(5) No company shall issue a prospectus or make an offer or invitation to the public or to its members exceeding ***five hundred*** for the subscription of its debentures, unless the company has, before such issue or offer, appointed one or more debenture trustees and the conditions governing the appointment of such trustees shall be such as may be prescribed.

(6) A debenture trustee shall take steps to protect the interests of the debentureholders and redress their grievances in accordance with such rules as may be prescribed.

(7) Any provision contained in a trust deed for securing the issue of debentures, or in any contract with the debenture-holders secured by a trust deed, shall be void in so far as it would have the effect of exempting a trustee thereof from, or indemnifying him against, any liability for breach of trust, where he fails to show the degree of care and due diligence required of him as a trustee, having regard to the provisions of the trust deed conferring on him any power, authority or discretion:
Provided that the liability of the debenture trustee shall be subject to such exemptions as may be agreed upon by a majority of debenture-holders holding not less than threefourths in value of the total debentures at a meeting held for the purpose.

(8) A company shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(9) Where at any time the debenture trustee comes to a conclusion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount as and when it becomes due, the debenture trustee may file a petition before the Tribunal and the Tribunal may, after hearing the company and any other person interested in the matter, by order, impose such restrictions on the incurring of any further liabilities by the company as the Tribunal may consider necessary in the interests of the debenture-holders.

(10) Where a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all of the debenture-holders, or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith on payment of principal and interest due thereon.

(11) If any default is made in complying with the order of the Tribunal under this section, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than two lakh rupees but which may extend to five lakh rupees, or with both.

(12) A contract with the company to take up and pay for any debentures of the company may be enforced by a decree for specific performance.

(13) The Central Government may prescribe the procedure, for securing the issue of debentures, the form of debenture trust deed, the procedure for the debenture-holders to inspect the trust deed and to obtain copies thereof, quantum of debenture redemption reserve required to be created and such other matters.

The Companies (Share Capital and Debentures) Rules, 2014

Rule 18 of the companies (Share Capital and Debentures) Rules, 2014 states that :
A company ***shall not issue secured debentures***, unless it complies with the following conditions, namely:-

(a) An issue of secured debentures may be made, provided the date of its redemption shall not exceed ***ten years*** from the date of issue.
Provided that a company engaged in the setting up of infrastructure projects may issue secured debentures for a period exceeding ten years but not ***exceeding thirty years***;

(b) such an issue of debentures shall be secured by the creation of a charge, on the properties or assets of the company, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon;

(c) the company shall appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders ; and

(d) the security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on-
(i) any specific movable property of the company (not being in the nature of pledge); or
(ii) any specific immovable property wherever situate, or any interest therein.

Conditions for Appointment of Trustees

A company ***shall appoint debenture trustees*** under sub-section (5) of section 71, after complying with the following conditions, namely:-

(a) the names of the debenture trustees shall be stated in letter of offer inviting subscription for debentures and also in all the subsequent notices or other communications sent to the debenture holders;

(b) before the appointment of debenture trustee or trustees, a written consent shall be obtained from such debenture trustee or trustees proposed to be appointed and a statement to that effect shall appear in the letter of offer issued for inviting the subscription of the debentures;

(c) A person ***shall not be appointed as a debenture trustee***, if he-
(i) beneficially holds shares in the company;
(ii) is a promoter, director or key managerial personnel or any other officer or an employee of the company or its holding, subsidiary or associate company;
(iii) is beneficially entitled to moneys which are to be paid by the company otherwise than as remuneration payable to the debenture trustee;
(iv) is indebted to the company, or its subsidiary or its holding or associate company or a subsidiary of such holding company;
(v) has furnished any guarantee in respect of the principal debts secured by the debentures or interest thereon;

(vi) has any pecuniary relationship with the company amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

(vii) is relative of any promoter or any person who is in the employment of the company as a director or key managerial personnel

Duties of Trustee

It ***shall be the duty of every debenture trustee*** to-

(a) satisfy himself that the letter of offer does not contain any matter which is inconsistent with the terms of the issue of debentures or with the trust deed;

(b) satisfy himself that the covenants in the trust deed are not prejudicial to the interest of the debenture holders;

(c) call for periodical status or performance reports from the company;

(d) communicate promptly to the debenture holders defaults, if any, with regard to payment of interest or redemption of debentures and action taken by the trustee therefor;

(e) appoint a nominee director on the Board of the company in the event of-

(i) two consecutive defaults in payment of interest to the debenture holders; or

(ii) default in creation of security for debentures; or

(iii) default in redemption of debentures.

(f) ensure that the company does not commit any breach of the terms of issue of debentures or covenants of the trust deed and take such reasonable steps as may be necessary to remedy any such breach;

(g) inform the debenture holders immediately of any breach of the terms of issue of debentures or covenants of the trust deed;

(h) ensure the implementation of the conditions regarding creation of security for the debentures, if any, and debenture redemption reserve;

(i) ensure that the assets of the company issuing debentures and of the guarantors, if any, are sufficient to discharge the interest and principal amount at all times and that such assets are free from any other encumbrances except those which are specifically agreed to by the debenture holders;

(j) do such acts as are necessary in the event the security becomes enforceable;

(k) call for reports on the utilization of funds raised by the issue of debentures-

(l) take steps to convene a meeting of the holders of debentures as and when such meeting is required to be held;

(m) ensure that the debentures have been converted or redeemed in accordance with the terms of the issue of debentures;

(n) perform such acts as are necessary for the protection of the interest of the debenture holders and do all other acts as are necessary in order to resolve the grievances of the debenture holders.

Creation of Debenture Redemption Reserve

The company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below-

(a) the Debenture Redemption Reserve shall be created out of the profits of the company ***available for payment of dividend***;

(b) the company shall create Debenture Redemption Reserve (DRR) in accordance with following conditions:-

(i) No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures. For other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013, DRR will be as applicable to NBFCs registered with RBI.

(ii) For NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997, 'the adequacy' of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008, and no DRR is required in the case of privately placed debentures.

(iii) For other companies including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities), Regulations 2008 and also 25% DRR is required in the case of privately placed debentures by listed companies. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of debentures.

(c) every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than fifteen percent, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-

(i) in deposits with any scheduled bank, free from any charge or lien;

(ii) in unencumbered securities of the Central Government or of any State Government;

(iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

(iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;

(v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above:
Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

(d) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.

(e) the amount credited to the Debenture Redemption Reserve shall not be utilised by the company except for the purpose of redemption of debentures.

SEBI (Issue and Listing of Debt Securities) Regulations, 2008

Some of the regulations for public issue of debt securities are given below :

(1) No issuer shall make any public issue of debt securities* if the issuer or the person in control of the issuer, or its promoter, has been restrained or prohibited or debarred by the Board from accessing the securities market or dealing in securities and such direction or order is in force.

(2) No issuer shall make a public issue of debt securities* unless following conditions are satisfied, as on the date of filing of draft offer document and final offer document as provided in these regulations:

(a) it has made an application to one or more recognized stock exchanges for listing of such securities therein;
Provided that where the application is made to more than one recognized stock exchanges, the issuer shall choose one of them as the designated stock exchange.

(b) it has obtained in-principle approval for listing of its debt securities on the recognized stock exchanges where the application for listing has been made;

(c) credit rating has been obtained from ***at least one credit rating agency*** registered with the Board and is disclosed in the offer document:
Provided that where credit ratings are obtained from more than one credit rating agencies, all the ratings, including the unaccepted ratings, shall be disclosed in the offer document;

(d) it has entered into an arrangement with a ***depository*** registered with the Board for dematerialization of the debt securities that are proposed to be issued to the public, in accordance with the Depositories Act,1996 and regulations made thereunder.

(3) The issuer shall appoint one or more merchant bankers registered with the Board at least one of whom shall be a lead merchant banker.

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*Debt securities means a non-convertible debt securities which create or acknowledge indebtedness and include debentures, bonds and other securities.

(4) The issuer shall appoint one or more debenture trustees in accordance with the provisions of Section 71 of the Companies Act, 2013.

(5) The issuer shall not issue debt securities for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management.

Price Discovery through Book Building

The issuer may determine the price of debt securities in consultation with the lead merchant banker and the issue may be at fixed price or the price may be determined through book building process in accordance with the procedure as may be specified by the Board.

Minimum subscription

(1) The issuer may decide the amount of minimum subscription which it seeks to raise by issue of debt securities and disclose the same in the offer document.

(2) In the event of non receipt of minimum subscription all application moneys received in the public issue shall be refunded forthwith to the applicants.

Underwriting

A public issue of debt securities may be underwritten by an underwriter registered with the Board and in such a case adequate disclosures regarding underwriting arrangements shall be disclosed in the offer document.

Debenture Redemption Reserve

(1) For the redemption of the debt securities issued by a company, the issuer shall create debenture redemption reserve in accordance with the provision of the Companies Act.

(2) Where the issuer has defaulted in payment of interest on debt securities or redemption thereof or in creation of security as per the terms of the issue of debt securities, any ***distribution of dividend*** shall require approval of the ***debenture trustees***.

Right to recall or redeem prior to maturity [w.e.f. 24th March, 2015]

An issuer making public issue of debt securities may recall such securities prior to maturity date at his option (call) or provide such right of redemption prior to maturity date (put) to all the investors or only to retail investors, at their option, subject to the following:

a) Such right to recall or redeem debt securities prior to maturity date is exercised in accordance with the terms of issue and detailed disclosure in this regard is made in the offer document including date from which such right is exercisable, period of exercise (which shall not be less than ***three*** working days), redemption amount (including the premium or discount at which such redemption shall take place);

b) The issuer or investor may exercise such right with respect to all the debt securities issued or held by them respectively or with respect to a part of the securities so issued or held ;

c) In case of partial exercise of such right in accordance with the terms of the issue by the issuer , it shall be done on proportionate basis only;

d) No such right shall be exercisable before expiry of ***twenty four months*** from the date of issue of such debt securities;

e) Issuer shall send notice to all the eligible holders of such debt securities ***at least twenty one days*** before the date from which such right is exercisable;

f) Issuer shall also provide a copy of such notice to the stock exchange where the such debt securities are listed for wider dissemination and shall make an advertisement in the national daily having wide circulation indicating the details of such right and eligibility of the holders who are entitled to avail such right;

g) Issuer shall pay the redemption proceeds to the investors along with the interest due to the investors within ***fifteen days*** from the last day within which such right can be exercised;

h) Issuer shall pay interest at the rate of fifteen per cent. per annum for the period of delay, if any,

i) After the completion of the exercise of such right, the issuer shall submit a detailed report to the stock exchange for public dissemination regarding the debt securities redeemed during the exercise period and details of redemption thereof.

Explanation.- For the purpose of this regulation, retail investor shall mean the holder of debt securities having face value not more than ₹ two lakh.

Presentation of Debentures in the Balance Sheet

As per 'Schedule III' the debentures are shown under main heading — '***Non-Current Liabilities***' and sub-heading '***Long-term Borrowings***'. The details of debentures are shown in the 'Notes to Accounts', e.g., (i) debentures shall further be sub-classified as secured and unsecured; (ii) nature of security shall be specified separately in each case; (iii) debentures (along with the rate of interest and particulars of redemption or conversion as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

Example

X Ltd. issued 10,000, 12% Debentures of ₹ 100 each payable in full on application by 31st May, 2016. Applications were received for 12,000 debentures. Debentures were allotted on 9th June, 2016. Excess monies were refunded on the same date. Show relevant items in the Balance Sheet. All debentures are secured.

The ***relevant items*** will appear in the Balance sheet as follows :

Balance Sheet of X Ltd. as at 9th June, 2016 [Extract],

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus		
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(1)	10,00,000
(4) Current Liabilities :		?
TOTAL		
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(b) Non-current Investments		?
(c) Deferred Tax Assets (Net)		?
(d) Long-term Loans and Advances		?
(e) Other Non-current Assets		?
(2) Current Assets :		
(a) Current Investments		?
(b) Inventories		?
(c) Trade Receivables		?
(d) Cash and Cash Equivalents		10,00,000
TOTAL		

Notes to Accounts :
(1) Long-term Borrowings (Secured)

Particulars	₹
10,000, 12% Debentures of ₹ 100 each	10,00,000

Recording the Issue of Debentures

Just like shares, money payable on debentures may be paid either in full with application or by instalments. Accounting entries will differ to some extent in either case.

Debentures Payable in Full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures, such as 10% Debentures Application Account or 12% Debentures Application Account. These accounts record moneys received from the applicants of debentures. If an issue is over-subscribed, these accounts can be used to record the refund of moneys to the unsuccessful applicants. At the time of allotment of debentures, the amount in Debentures Application Account is transferred to the respective Debentures Account.

Debentures may be issued at par, at a premium, or at a discount.

Debentures Issued at Par

The face value and issue price are same when the debentures are issued at par; that is, if a debenture with a nominal value of ₹ 100 is issued at par, the company receives ₹ 100.

The accounting entries would be as follows :

(a) When cash is received

Bank Account Dr.
To Debentures Application Account
(Being money received on ... debentures @ ₹ ... each)

(b) *When excess money is refunded*

Debentures Application Account Dr.
To Bank Account
(Being excess money on ... debentures refunded as per Board's Resolution No. ... dated ...)

(c) When the debentures are allotted

Debentures Application Account Dr.
To Debentures Account
(Being the allotment of ... debentures of ₹ ... each as per Board's Resolution No... dated ...)

Illustration 1

Simmons Ltd issued 10,000, 12% Debentures of ₹ 100 each at par payable in full on application by 1st April, 2017. Applications were received for 11,000 Debentures. Debentures were allotted on 7th April, 2017. Excess money were refunded on the same date.

You are required to pass necessary Journal Entries (including cash transactions) in the books of the company and also show the Ledger Accounts.

Solution

In the books of Simmons Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 April 1	Bank A/c	Dr.	11,00,000	
	To 12% Debentures Application A/c			11,00,000
	(Being money received for 11,000 debentures @ ₹ 100 each)			
April 7	12% Debentures Application A/c	Dr.	1,00,000	
	To Bank A/c			1,00,000
	(Being money on 1,000 debentures refunded as per Board's Resolution No. ... dated ...)			
April 7	12% Debentures Application A/c	Dr.	10,00,000	
	To 12% Debentures A/c			10,00,000
	(Being the allotment of 10,000 debentures of ₹ 100 each at par, as per Board's Resolution No.. dtd..)			

Dr. **Bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To 12% Debentures Application A/c	11,00,000	7.4.2017	By 12% Debentures Application A/c	1,00,000
			7.4.2017	By Balance c/d	10,00,000
		11,00,000			11,00,000

Dr. **12% Debentures Application Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
7.4.2017	To Bank A/c	1,00,000	1.4.2017	By Bank A/c	11,00,000
7.4.2017	To 12% Debentures A/c	10,00,000			
		11,00,000			11,00,000

Dr. **12% Debentures Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
7.4.2017	To Balance c/d	10,00,000	7.4.2017	By 12% Debentures Application A/c	10,00,000

Debentures Issued at a Premium

Debentures are rarely issued at a premium. A company issues debentures at a premium when the market rate of interest is lower than the debenture interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at 10% premium, the company receives ₹ 110 where the investor gets slightly less interest than stated in the debenture.

For example, 12% Debentures of ₹ 100 issued at a premium of 10%. The investor will get ₹ 12 p.a. for his investment of 110. Therefore, the ***effective rate of interest*** on investment is (12/110 x 100) = 10.91%.

The accounting entries would be as follows:

(a) When cash is received

Bank Account Dr. [Nominal value plus premium]
  To Debentures Application Account
(Being money received on ....debentures @ ₹ .... each including premium of ₹ ... each)

(b) When excess money is refunded

Debentures Application Account Dr.
  To Bank Account
(Being refund of money on ...... debentures @ ₹ .... each, as per Board's Resolution No .... dated ....)

(c) When the debentures are allotted

Debentures Application Account Dr.
  To Debentures Account
  To Debentures Premium Account
(Being the allotment of .... debentures, premium transferred to Debentures Premium Account, as per Board's Resolution No ...... dated .....)

(d) When debentures premium is transferred

Debentures Premium Account Dr.
  To Capital Reserve Account
(Being the amount transferred to capital reserve)

Illustration 2

Kapil Ltd. issued 10,000, 12% Debentures of ₹ 100 each at a premium of 10% payable in full on application by 1st March, 2017. The issue was fully subscribed and debentures were allotted on 9th March 2017.

Pass necessary Journal Entries (including cash transactions).

Solution **In the books of Kapil Limited**

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 March 1	Bank A/c	Dr.	11,00,000	
	To 12% Debentures Application A/c			11,00,000
	(Being the money received on 10,000 debentures @ ₹ 110 each including premium of ₹ 10 each)			
March 9	12% Debentures Application A/c	Dr.	11,00,000	
	To 12% Debentures A/c			10,00,000
	To Debentures Premium A/c			1,00,000
	(Being the allotment of 10,000 debentures of ₹ 100 each, premium @ ₹ 10 each transferred to Debenture Premium Account as per Board's Resolution No. ... dated ...)			
	Debenture Premium A/c	Dr.	1,00,000	
	To Capital Reserve A/c			1,00,000
	(Being the debenture premium transferred to capital reserve)			

Debentures Issued at a Discount

The Companies Act does not impose any restriction on the price at which debentures can be issued. Unlike shares, there is no maximum limit for discount on issue of debenture. This is why it is very common that debentures are issued at a discount.

The debentures which are issued at a discount are issued at a lower price than nominal value, that is, if a debenture with a nominal value of ₹ 100 is issued at 10% discount, the company receives ₹ 90 only. The issue of debentures at a discount slightly increases the true rate of interest payable.

For example, 12% Debentures of ₹ 100 issued at a discount of 10%. The Company will have to pay ₹ 12 for a loan of ₹ 90. Therefore, the true rate of interest is (12/90 × 100) = 13.33%.

A company issues debentures at a discount when the market rate of interest is ***higher*** than the debenture interest rate. Like shares, Debentures Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "***Discount on Issue of Debentures Account***." In the Balance Sheet, "Discount on Issue of Debentures" is shown as a negative figure under 'R***eserve and Surplus***'. It is generally adjusted against ***securities premium or surplus*** if it is there in the Balance Sheet at the time of issue of debentures.

In many cases, companies are writing off discount on issue of debentures on equitable basis over different years. In this case, only balance amount is carried forward to next year and shown under 'Reserve and Surplus' as a ***negative figure***.

Accounting Entries

(a) When cash is received

Bank Account Dr. [Actual cash received]
    To Debentures Application Account
(Being money received on ... debentures @ ₹ ... each)

(b) When excess money is refunded

Debentures Application Account Dr.
    To Bank Account
(Being excess money on ... debentures refunded as per Board's Resolution No ... dated ...)

(c) When the debentures are allotted

Debentures Application Account Dr. [Actual cash received]
Discount on Issue of Debentues Account Dr. [Discount on debentures]
    To Debentures Account [Nominal value of debentures]
(Being the allotment of ... debentures of ₹ ... each @ ₹ ... each as per Board's Resolution No ... dated ...)

(d) When Discount on Issue of Debentures is written-off

Securities Premium Account / Statement of Profit and Loss Dr.
To Discount on Issue of Debentures
(Being discount on issue of debentures written-off)

Illustration 3

Z Ltd issued 15,000, 10% Debentures of ₹ 100 each at a discount of 10% payable in full on application by 1st April, 2016. At the time of issuance of Debentures, the balance of Securities Premium was ₹ 2,00,000.

Applications were received for 18,000 debentures.

Debentures were allotted on 15th April, 2016. Excess monies were refunded on the same date.

Pass necessary journal entries (including cash transactions).

Also show Ledger Accounts and Balance Sheet after issue.

Solution

In the books of Z Ltd

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016					
April 1	Bank A/c	Dr.		16,20,000	
	To 10% Debentures Application A/c				16,20,000
	(Being money received for 18,000 debentures @ ₹ 90 each)				
15	10% Debentures Application A/c	Dr.		2,70,000	
	To Bank A/c				2,70,000
	(Being excess money on 3,000 debentures @ ₹ 90 each refunded as per Board's Resolution No. . . . dated . . .)				
	10% Debentures Application A/c	Dr.		13,50,000	
	Discount on Issue of Debentures A/c	Dr.		1,50,000	
	To 10% Debentures A/c				15,00,000
	(Being the allotment of 15,000 debentures of ₹ 100 each at a discount of ₹ 10 each as per Board's Resolution No. . . . dated . . .)				
	Securities Premium A/c	Dr.		1,50,000	
	To Discount on Issue of Debentures A/c				1,50,000
	(Being the discount on issue of debentures adjusted against Securities Premium)				

Dr. Bank Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
April 1	To 10% Debentures Application A/c	16,20,000	April 15	By 10% Debentures Application A/c	2,70,000
			"	By Balance c/d	13,50,000
		16,20,000			16,20,000

Dr. 10% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
April 15	To Balance c/d	15,00,000	April 15	By 10% Debentures Application A/c	13,50,000
				By Disc. on Issue of Debentures A/c	1,50,000
		15,00,000			15,00,000

Dr. 10% Debentures Application Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
April 15	To Bank A/c	2,70,000	April 15	By Bank A/c	16,20,000
"	To 10% Debentures A/c	13,50,000			
		16,20,000			16,20,000

Dr. **Discount on Issue of Debentures Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
April 15	To 10% Debentures A/c	1,50,000	April 15	By Securities Premium A/c	1,50,000

Dr. **Securities Premium Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016			2016		
April 15	To Discount on Issue of Debentures A/c	1,50,000	April 1	By Balance b/d	2,00,000
"	To Balance c/d	50,000			
		2,00,000			2,00,000

Balance Sheet of Z Ltd. as at 15th April, 2016 [Extract],

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus	(1)	50,000
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	15,00,000
(4) Current Liabilities :		?
TOTAL		
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(b) Non-current Investments		?
(c) Deferred Tax Assets (Net)		?
(d) Long-term Loans and Advances		?
(e) Other Non-current Assets		?
(2) Current Assets :		
(a) Current Investments		?
(b) Inventories		?
(c) Trade Receivables		?
(d) Cash and Cash Equivalents	(3)	13,50,000
TOTAL		

Notes to Accounts :

(1) Reserve and Surplus

Particulars	₹
Securities Premium	50,000

(3) Cash and Cash Equivalents

Particulars	₹
Cash at Bank	13,50,000

(2) Long-term Borrowings (Secured)

Particulars	₹
15,000, 10% Debentures of ₹ 100 each	15,00,000

Tutorial Note : As per Schedule III of the Companies Act, 2013, no 'Miscellaneous Expenditure' is to be shown on the assets side of the Balance Sheet. If there is any item, e.g., discount on issue of debentures, loss on issue of debentures or commission on issue of shares or debentures, it should be shown under 'Reserve and Surplus' on the 'Equity and Liability' section of the Balance Sheet. If there is no balance of Reserve and Surplus, it is to be shown as a negative balance.

Accounting Entries at Issue, when Debentures are Redeemable :
(i) at par; (ii) at a discount; or (iii) at a premium

Where debentures are to be redeemed at par or at a discount (rare in practice), no extra entry is to be made ***at the time of issue and allotment of debentures***. For better understanding, we would like to show the entries in the following manner :

Case 1: **When debentures are issued at par and redeemable at par or at a discount**

(a) Bank Account Dr.
To Debentures Application Account
(b) Debentures Application Account Dr.
To Debentures Account

Case 2: **When debentures are issued at a discount and redeemable at par or at a discount**

(a) Bank Account Dr.
To Debentures Application Account
(b) Debentures Application Account Dr.
Discount on Issue of Debentures Account Dr.
To Debentures Account

Case 3: **When debentures are issued at a premium but redeemable at par or at a discount**

(a) Bank Account Dr.
To Debentures Application Account
(b) Debentures Application Account Dr.
To Debentures Account
To Debentures Premium Account

Where debentures are to be redeemed at a premium, an extra entry is to be made at the time of issue and allotment of debentures. This extra entry is to be passed for providing premium payable on

The accounting entries are as follows :

Case 1 : **When debentures are issued at par but redeemable *at a premium***

(a) Bank Account Dr.
To Debentures Application Account
(b) Debentures Application Account Dr.
To Debentures Account
(c) Loss on Issue of Debentures Account Dr. [For providing premium payable on redemption]
To Premium on Redemption of Debentures Account

Students should note that, instead of passing the separate entries above, a combined entry can be passed.

Bank Account Dr.
Loss on Issue of Debentures Account Dr.
To Debentures Account
To Premium on Redemption of Debentures Account

"Loss on Issue of Debentures" should be treated in the same way as the "Discount on Issue of Debentures". "Premium on Redemption of Debentures" should be shown on the liabilities section of the Balance Sheet till the date of redemption of debentures.

Case 2 : **When debentures are issued at a discount but redeemable *at a premium***

(a) Bank Account Dr.
  To Debentures Application Account
(b) Debentures Application Account Dr.
  Discount on Issue of Debentures Account Dr.
  To Debentures Account
(c) Loss on Issue of Debentures Account Dr. [For providing premium on redemption]
  To Premium on Redemption of Debentures Account

Alternatively :
Bank Account Dr.
Discount on Issue of Debentures Account Dr.
Loss on Issue of Debentures Account Dr.
  To Debentures Account
  To Premium on Redemption of Debentures Account

Case 3 : **When debentures are issued at a premium and redeemable *at a premium***

(a) Bank Account Dr.
  To Debentures Application Account
(b) Debentures Application Account Dr.
  To Debentures Account
  To Debentures Premium Account
(c) Loss on Issue of Debentures Account Dr.
  To Premium on Redemption of Debentures Account

Alternatively :
Bank Account Dr.
Loss on Issue of Debentures Account Dr.
  To Debentures Account
  To Premium on Redemption of Debentures Account
  To Debentures Premium Account

In this case, debentures premium can be adjusted with the loss on issue of debentures at the year-end.

Illustration 4

Show by means of Journal Entries how will you record the following issues :

(a) P Ltd. issues 5,000, 10% debentures of ₹ 100 each at a discount of 5%, redeemable at the end of 5 years at par.
(b) Q Ltd. issues 5,000, 11% debentures of ₹ 100 each at par, redeemable at the end of 5 years at a premium of 5%.
(c) R Ltd. issues 5,000, 12% debentures of ₹ 100 each at a discount of 5%, redeemable at the end of 5 years at a premium of 5%.
(d) S Ltd. issues 5,000, 13% debentures of ₹ 100 each at a premium of 5%, redeemable at the end of 5 years at a premium of 5%. ***[I.C.W.A. (Inter) — Adapted]***

Solution
(a)

In the books of P Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
?	Bank A/c	Dr.	4,75,000	
	To Debentures Application A/c			4,75,000
	(Being application money received for 5,000, 10% debentures @ ₹ 95 each)			
?	Debentures Application A/c	Dr.	4,75,000	
	Discount on Issue of Debentures A/c	Dr.	25,000	
	To 10% Debentures A/c			5,00,000
	(Being the issue of 5,000 debentures of ₹ 100 each at a discount of 5% and redeemable at par as per Board's Resolution No ... dated ...)			

(b)

In the books of Q Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
?	Bank A/c	Dr.	5,00,000	
	To Debentures Application A/c			5,00,000
	(Being application money received for 5,000, 11% debentures @ ₹ 100 each)			
?	Debentures Application A/c	Dr.	5,00,000	
	To 11% Debentures A/c			5,00,000
	(Being the issue of 5,000 11% debentures at par and redeemable at a premium of 5% as per Board's Resolution No ... dated ...)			
?	Loss on Issue of Debentures A/c	Dr.	25,000	
	To Premium on Redemption of Debentures A/c			25,000
	(Being the provision for premium payable on redemption)			
	Alternative entry may be :			
	Bank A/c	Dr.	5,00,000	
	Loss on Issue of Debentures A/c	Dr.	25,000	
	To 11% Debentures A/c			5,00,000
	To Premium on Redemption of Debentures A/c			25,000
	(Being the issue of 5,000 11% debentures of ₹ 100 each at par and redeemable at a premium of 5%)			

(c)

In the books of R Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
?	Bank A/c	Dr.	4,75,000	
	To Debentures Application A/c			4,75,000
	(Being application money received for 5,000, 12% debentures @ ₹ 95 each)			
?	Debentures Application A/c	Dr.	4,75,000	
	Discount on Issue of Debentures A/c	Dr.	25,000	
	To 12% Debentures A/c			5,00,000
	(Being the issue of 5,000 12% debentures of ₹ 100 each at 5% discount and redeemable at 5% premium as per Board's Resolution No ... dated ...)			
?	Loss on Issue of Debentures A/c	Dr.	25,000	
	To Premium on Redemption of Debentures A/c			25,000
	(Being the provision for premium payable on redemption)			
	Alternative (1) entry may be :			
	Bank A/c	Dr.	4,75,000	
	Discount on Issue of Debentures A/c	Dr.	25,000	
	Loss on Issue of Debentures A/c	Dr.	25,000	
	To 12% Debentures A/c			5,00,000
	To Premium on Redemption of Debentures A/c			25,000
	(Being the issue of 5,000 12% debentures of ₹ 100 each at a discount of 5% and redeemable at a premium of 5% as per Board's Resolution No ... dated ...)			
	Alternative (2) entry may be :			
	Bank A/c	Dr.	4,75,000	
	Loss on Issue of Debentures A/c	Dr.	50,000	
	To 12% Debentures A/c			5,00,000
	To Premium on Redemption of Debentures A/c			25,000
	(Being the issue of 5,000 12% debentures of ₹ 100 each at a discount of 5% and redeemable at a premium of 5% as per Board's Resolution No ... dated ...)			

(d) **In the books of S Limited**
Journal

Date	Particulars		Dr. ₹	Cr. ₹
?	Bank A/c	Dr.	5,25,000	
	To Debentures Application A/c			5,25,000
	(Being application money received for 5,000, 13% debentures @ ₹ 105 each)			
?	Debentures Application A/c	Dr.	5,25,000	
	To 13% Debentures A/c			5,00,000
	To Debentures Premium A/c			25,000
	(Being the issue of 5,000 13% debentures of ₹ 100 each at a premium of 5% and redeemable at 5% premium as per Board's Resolution No ... dated ...)			
?	Loss on Issue of Debentures A/c	Dr.	25,000	
	To Premium on Redemption of Debentures A/c			25,000
	(Being the provision for premium payable on redemption)			
	Alternative entry may be :			
	Bank A/c	Dr.	5,25,000	
	Loss on Issue of Debentures A/c	Dr.	25,000	
	To 13% Debentures A/c			5,00,000
	To Debentures Premium A/c			25,000
	To Premium on Redemption of Debentures A/c			25,000
	(Being the issue of 5,000 13% debentures of ₹ 100 each at a premium of 5% and redeemable at a premium of 5% as per Board's Resolution No ... dated ...)			
	Debentures Premium A/c	Dr.	25,000	
	To Loss on Issue of Debentures A/c			25,000
	(Being the adjustment for premium received on issue with the premium payable on redemption)			

Tutorial Note : Discount on Issue of Debentures, Loss on Issue of Debentures are to be adjusted against Reserve and Surplus in total.

Debentures Payable by Instalments

Where a company does not require the immediate use of all the money to be collected by issue of debentures, it may issue debentures payable by instalments, for example, 20% with application; 30% with allotment; and balance in final call. Prospectus contains the details of money payable (both amount and date).

In this case also debentures may be issued:

(i) at par;
(ii) at a discount; or
(iii) at a premium.

The accounting entries are similar to that of issue of shares.

Debentures Issued at par

Accounting Entries

(a) When application money is received

Bank Account Dr.
To Debentures Application Account

(b) When excess application money is refunded

Debentures Application Account Dr.
To Bank Account
(Being the refund of excess application money on ...... debentures as per Board's Resolution No ....dated ......)

(c) When the debentures are allotted

(i) Debentures Application Account Dr.
To Debentures Account
(Being the allotment of .....debentures as per Board's Resolution No....... dated.........)

(ii) Debentures Allotment Account Dr.
To Debentures Account
(Being allotment money due on.....debentures @ ₹ ....each as per Board's Resolution No... dated........)

(d) When allotment money is received

Bank Account Dr.
To Debentures Allotment Account
(Being allotment money received)

(e) When call money is due

Debentures Call Account Dr.
To Debentures Account
(Being call money due on........ debentures @ ₹ .... each as per Board's Resolution No....dated.........)

(f) When call money is received

Bank Account Dr.
To Debentures Call Account
(Being call money received on........ debentures @ ₹ ......each)

Illustration 5

X Ltd issued 10,000, 12% Debentures of ₹ 100 each at par on 1st April 2017, payable on the following terms:

On application ₹ 40; On allotment ₹ 30; and On call ₹ 30 (on 1st August, 2017). Applications were received for 12,000 debentures and all the application money was received by 15th May, 2017. Allotment was made on 1st June 2017, and allotment money was received in full on 20th June, 2017. The call was made on the due date and fully paid on 20th August 2017.

Pass necessary Journal Entries (including cash transactions).

Solution

In the books of X Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 May 15	Bank A/c To Debentures Application A/c (Being the application money received for 12,000 debentures @ ₹ 40 each)	Dr.	4,80,000	4,80,000
June 1	Debentures Application A/c To Bank A/c (Being the excess application money on 2,000 debentures @ ₹ 40 each refunded as per Board's Resolution No. ... dated ...)	Dr.	80,000	80,000
June 1	Debentures Application A/c To 12% Debentures A/c (Being the allotment of 10,000 debentures as per Board's Resolution No. ... dated ...)	Dr.	4,00,000	4,00,000
June 1	Debentures Allotment A/c To 12% Debentures A/c (Being the allotment money due on 10,000 debentures @ ₹ 30 each as per Board's Resolution No. ... dated ...)	Dr.	3,00,000	3,00,000
June 20	Bank A/c To Debentures Allotment A/c (Being the allotment money received in full)	Dr.	3,00,000	3,00,000
Aug 1	Debentures Call A/c To 12% Debentures A/c (Being the call money due on 10,000 debentures @ ₹ 30 each as per Board's Resolution No. ... dtd ...)	Dr.	3,00,000	3,00,000

Aug 20	Bank A/c To Debentures Call A/c (Being the call money received in full)	Dr.	3,00,000	3,00,000

Debentures Issued at a Discount

We have already mentioned that debentures can also be issued at a discount. Debentures Account is shown in the Balance Sheet at nominal value under ***'Non-current Liabilities'*** as 'Long-term Borrowings'and discount on issue of debentures is adjusted against 'Reserve and Surplus'.

Discount on debentures is generally adjusted with the allotment (it can also be adjusted with the application as per the terms and conditions of issue).

Accounting Entries

(a) When application money is received

Bank Account Dr.
To Debentures Application Account
(Being application money received on....debentures @₹ .... each)

(b) When excess application money is refunded

Debentures Application Account Dr.
To Bank Account
(Being the refund of excess application money on.... debentures as per Board's Resolution No......dated.......)

(c) When debentures are allotted

(i) Debentures Application Account Dr.
To Debentures Account
(Being the allotment of .... debentures of ₹ .....each as per Board's Resolution No........dated........)

(ii) Debentures Allotment Account Dr.
Discount on Issue of Debentures Account Dr.
To Debentures Account
(Being the allotment money due on .. debenture @ ₹ .. each as per Board's Resolution No.. dt ...)

(d) When allotment money is received

Bank Account Dr.
To Debentures Allotment Account
(Being allotment money received)

(e) When call money is due

Debentures Call Account Dr.
To Debentures Account
(Being call money due on....debentures @ ₹... each as per Board's Resolution No........dated.......)

(f) When call money is received

Bank Account Dr.
To Debentures Call Account
(Being call money received)

Illustration 6

Y Ltd. issued 1,000, 11% Debentures of ₹ 100 each at a discount of 10% on 1st March 2017, payable on the following terms: On application ₹ 60; On allotment ₹ 20 (after adjusting discount); and On call ₹ 10.

The issue was fully subscribed and all money was received in full. Pass necessary Journal Entries (including cash transactions) and also show the relevant portion of the Balance Sheet after issue of debentures.

Solution

In the books of Y Limited
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2017 March 1	Bank A/c Dr. To Debentures Application A/c (Being the application money received on 1,000 debentures @ ₹ 60 each)	60,000	60,000
?	Debenture Application A/c Dr. To 11% Debentures A/c (Being the allotment of 1,000 debentures of ₹ 100 each as per Board's Resolution No. ... dated ...)	60,000	60,000
?	Debentures Allotment A/c Dr. Discount on Issue of Debentures A/c Dr. To 11% Debentures A/c (Being the allotment money due on 1,000 debentures @ ₹ 20 each after adjusting discount as per Board's Resolution No. ... dated ...)	20,000 10,000	30,000
?	Bank A/c Dr. To Debentures Allotment A/c (Being the allotment money received)	20,000	20,000
?	Debentures Call A/c Dr. To 11% Debentures A/c (Being the call money due on 1,000 debentures @ ₹ 10 each as per Board's Resolution No. ... dtd ...)	10,000	10,000
?	Bank A/c Dr. To Debentures Call A/c (Being the call money received on 1000 debentures @ ₹ 10 each)	10,000	10,000

Balance Sheet of Y Ltd. as at ... [Extract],

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus	(1)	(10,000)
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	1,00,000
(b) Deferred Tax Liabilities (Net)		?
(c) Other Long-term Liabilities		?
(d) Long-term Provisions		?
(4) Current Liabilities :		?
(a) Short-term Borrowings		?
(b) Trade Payables		?
(c) Other Current Liabilities		?
(d) Short-term Provisions		?
TOTAL		
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		?
(ii) Intangible Assets		?
(iii) Capital Work-in-progress		?
(iv) Intangible Assets under Development		?

(b) Non-current Investments		?
(c) Deferred Tax Assets (Net)		?
(d) Long-term Loans and Advances		?
(e) Other Non-current Assets		?
(2) Current Assets :		
(a) Current Investments		?
(b) Inventories		?
(c) Trade Receivables		?
(d) Cash and Cash Equivalents		90,000
(e) Short-term Loans and Advances		?
(f) Other Current Assets		?
TOTAL		

Notes to Accounts :

(1) Reserve and Surplus

Particulars	₹
Discount on Issue of Debentures	(10,000)

(2) Long-term Borrowings (Secured)

Particulars	₹
1,000, 12% Debentures of ₹ 100 each	1,00,000

Debentures Issued at a Premium

Debentures may be issued at a premium, just like shares. Debentures Account is credited with the nominal value. Debentures premium is credited to a separate account and it is shown in the Balance Sheet under the heading ***"Reserves & Surplus"***. There is no restriction in the Companies Act regarding the utilisation of debentures premium. It is generally used for writing off debenture issue expenses, discount on issue of shares etc. Premium may be collected on application or on allotment.

Accounting Entries [Assuming premium is payable on ***application***]

(a) When application money is received

Bank Account Dr. [Including premium]
To Debentures Application Account

(b) When excess application money is refunded

Debentures Application Account Dr.
To Bank Account [Including premium]

(c) When debentures are allotted

(i) Debentures Application Account Dr.
To Debentures Account
To Debentures Premium Account
(ii) Debentures Allotment Account Dr.
To Debentures Account

(d) When allotment money is received

Bank Account Dr.
To Debentures Allotment Account

(e) When call money is due

Debentures Call Account Dr.
To Debentures Account

(f) When call money in received

Bank Account Dr.
To Debentures Call Account

Accounting Entries [Assuming premium is payable on ***allotment***]

(a) When application money is received

Bank Account Dr.
  To Debentures Application Account

(b) When excess application money is refunded

Debentures Application Account Dr.
  To Bank Account

(c) When debentures are allotted

(i) Debentures Application Account Dr.
  To Debentures Account

(ii) Debentures Allotment Account Dr.
  To Debentures Account
  To Debentures Premium Account

(d) When allotment money is received

Bank Account Dr.
  To Debentures Allotment Account

(e) When call money is due

Debentures Call Account Dr.
  To Debentures Account

(f) When call money is received

Bank Account Dr.
  To Debentures Call Account

Unlike shares, debentures cannot be forfeited for non-payment of calls due. This is because, under Section 71(12) of the Companies Act 2013 a contract with a company to take up and pay for any debenture of the company may be enforced by a decree for specific performance.

Illustration 7

Z Ltd. issued 1,000 14% Debentures of ₹ 100 each at a premium of 10% on 1st May 2017, payable on the following terms:

On application ₹ 40; On allotment ₹ 40 (including premium); and the balance on the final call. The issue was fully subscribed and debentures were allotted in full.

Pass necessary Journal Entries (including cash transactions).

Solution

In the books of Z Limited
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2017	Bank A/c Dr.	40,000	
May 1	To Debentures Application A/c		40,000
	(Being the application money received on 1,000 debentures @ ₹ 40 each)		
?	Debentures Application A/c Dr.	40,000	
	To 14% Debentures A/c		40,000
	(Being the application money on 1,000 debentures @ ₹ 40 each transferred to 14% Debentures Account as per Board's Resolution No. ... dated ...)		
?	Debentures Allotment A/c Dr.	40,000	
	To 14% Debentures A/c		30,000
	To Debentures Premium A/c		10,000
	(Being the allotment money due on 1,000 debentures @ ₹ 40 each including premium of ₹ 10 as per Board's Resolution No. ... dated ...)		

?	Bank A/c Dr. To Debentures Allotment A/c (Being the allotment money received on 1,000 debentures @ ₹ 40 each)	40,000	40,000
?	Debentures Call A/c Dr. To 14% Debentures A/c (Being the debenture call money due on 1,000 debentures @ ₹ 30 each as per Board's Resolution No. ... dated ...)	30,000	30,000
?	Bank A/c Dr. To Debentures Call A/c (Being the call money received on 1,000 debentures @ ₹ 30 each)	30,000	30,000

Issue of Debentures other than for Cash

Debentures are also issued for considerations other than cash, such as for purchase of land, machinery, etc.

Accounting Entries

(i) When assets are purchased

Assets Account Dr.
To Vendor Account

(ii) When debentures are issued at par

Vendor Account Dr.
To Debentures Account

(iii) When debentures are issued at a discount

Vendor Account Dr.
Discount on Issue of Debentures Account Dr.
To Debentures Account
OR

(iv) When debentures are issued at a premium

Vendor Account Dr.
To Debentures Account
To Debenture Premium Account

Illustration 8

A B Ltd purchased building costing ₹ 4,05,000. It was agreed that the purchase consideration be paid by issue of 12% debentures of ₹ 100 each. Assuming that debentures have been issued (i) at par, and (ii) at a discount of 10%, pass journal entries.

Solution

In the books of AB Ltd
Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Building A/c Dr. To Vendor A/c (Being the purchase of building from the vendor)	4,05,000	4,05,000
	Debentures Issued at Par Vendor A/c Dr. To 12% Debentures A/c (Being the issue of debentures of ₹ 4,05,000 to the vendor to satisfy his dues)	4,05,000	4,05,000
	Debentures Issued at a Discount Vendor A/c Dr. Discount on Issue of Debentures A/c Dr To 12% Debentures A/c (Being the issue of debentures of ₹ 4,50,000 at 10% discount to the vendor to satisfy his dues)	4,05,000 45,000	4,50,000

Illustration 9

Y Ltd. purchased machinery for ₹ 90,000. Half of the amount was paid in cash and the remaining half by issue of 12% debentures of ₹ 100 each at a discount of ₹ 10 each. Pass necessary journal entries.

Solution

In the books of Y Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Machinery A/c	Dr.	90,000	
	To Vendor A/c			90,000
	(Being the purchase of machinery from the vendor)			
	Vendor A/c	Dr.	90,000	
	Discount on Issue of Debentures A/c	Dr.	5,000	
	To Bank A/c			45,000
	To 12% Debentures A/c			50,000
	(Being the payment of cash and issue of debentures of ₹ 50,000 to vendor to satisfy his dues)			

Illustration 10

Naresh & Co. Limited purchased a building worth ₹ 1,41,000. It issued 15% debentures of ₹ 100 each at a discount of 6% in satisfaction of the purchase price. Pass necessary journal entries.

Solution

In the books of Naresh & Co. Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Building A/c	Dr.	1,41,000	
	To Vendor A/c			1,41,000
	(Being the purchase of building from the vendor)			
	Vendor A/c	Dr.	1,41,000	
	Discount on Issue of Debentures A/c	Dr.	9,000	
	To 15% Debentures A/c			1,50,000
	(Being the issue of debentures of ₹ 1,50,000 to the vendor to satisfy his dues)			

Illustration 11

M Limited issues debentures of ₹ 80 each at a premium of ₹ 10 per debenture for satisfying the purchase price of machinery at ₹ 45,000. Pass journal entries for the same.

Solution

In the books of M Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Machinery A/c	Dr.	45,000	
	To Vendor A/c			45,000
	(Being the purchase of machinery from the vendor)			
	Vendor A/c	Dr.	45,000	
	To Debentures A/c			40,000
	To Premium on Issue of Debentures A/c			5,000
	(Being 5,000 debentures of ₹ 80 each at a premium of ₹ 10 per debentureissued to the vendor to satisfy his dues)			

Issue of Debentures as Collateral Security for Loan

Secondary or supporting security is called ***collateral security***. The lender realises this security when the original security is insufficient to cover the loan.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debentureholder who can exercise all the rights of a debentureholder. The holder of such debentures is entitled to interest only on the ***amount of loan, but not on the debentures***.

Accounting Method

There are two methods of showing these types of debentures in the accounts of a company.

Method 1

Under this method, no entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet, the fact of the debentures being issued and outstanding is not shown. The fact is disclosed in the '***Notes to Accounts***'.

Illustrative Example

X Ltd obtains a loan from ICICI of ₹ 20,00,000, giving as collateral security of ₹ 25,00,000, 14%, First Mortgage Debentures. In the Balance Sheet of X Ltd, it is shown as follows :

Balance Sheet of Y Ltd. as at ... [Extract],

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus		?
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(1)	20,00,000
(b) Deferred Tax Liabilities (Net)		?
(c) Other Long-term Liabilities		?
(d) Long-term Provisions		?
(4) Current Liabilities :		?
(a) Short-term Borrowings		?
(b) Trade Payables		?
(c) Other Current Liabilities		?
(d) Short-term Provisions		?
TOTAL		

Notes to Accounts :
(2) Long-term Borrowings (Secured)

Particulars	₹
ICICI Loan (colaterally secured by issue of ₹ 25,00,000, 14% First Mortgage Debentures)	20,00,000

Method 2

Under this method, the following entry is made to record the issue of such debentures:

Debentures Suspense Account   Dr.
To Debentures Account
(Being the issue of...debentures collaterally... as per Board's Resolution No ....dated)

It is to be noted that Debenture Suspense Account or Debenture Account will not be shown in the Balance Sheet. However, in the Notes to Account it is disclosed showing the details.

Illustrative Example

Taking the same information of the above example, the entry on issue will be as follows:

Solution

In the books of X Limited
Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Debentures Suspense A/c Dr. To 14% First Mortgage Debentures A/c (Being the issue of ₹ 25,00,000 debentures collaterally as per Board's Resolution No. ... dtd. ...)	25,00,000	 25,00,000

Balance Sheet of Y Ltd. as at ... [Extract],

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus		?
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(1)	20,00,000
(b) Deferred Tax Liabilities (Net)		?
(c) Other Long-term Liabilities		?
(d) Long-term Provisions		?
(4) Current Liabilities :		?
(a) Short-term Borrowings		?
(b) Trade Payables		?
(c) Other Current Liabilities		?
(d) Short-term Provisions		?
TOTAL		

Notes to Accounts :
(2) Long-term Borrowings (Secured)

Particulars	₹
ICICI Loan	20,00,000

14% First Mortgage Debentures have been issued as collateral securities which has been shown as follows:

25,000, 14% First Mortgage Debentures :	25,00,000
Less: Debenture Suspense Account	25,00,000
	Nil

Students should note that the Method 1 is much more logical from the accounting point of view. Therefore, we advise to follow Method 1.

Illustration 12

BA Limited made an issue, which was fully subscribed, of 1,000 debentures of ₹ 100 each at ₹ 97. The debentures were allotted on 31st July, 2016, subscriptions being payable 10% on application, 40% on allotment, 25% on first call on 30th September and the balance on final call on 30th November, 2016.

Under the terms of the issue, payment could be made in full on 31st July, 2016.

Interest on any amounts prepaid being allowable at the rate of 10% p.a.; such interest was not deductible from the subscriber's payment, but was payable by the company on 30th November, 2016.

The alloter of 300 debentures took advantage of the pre-paid terms, while others paid on the due date.

Journalise the entries to be made in the company's books (ignore debenture interest).

Solution **In the books of Z Limited**

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016	Bank A/c	Dr.	10,000	
	To Debentures Application A/c			10,000
	(Being application money received on 1,000 debentures @ ₹ 10 each)			
July 31	Debentures Application A/c	Dr.	10,000	
	To Debentures A/c			10,000
	(Being the allotment of 1,000 debentures as per Board's Resolution No. . . . dated. . .)			
	Debentures Allotment A/c	Dr.	40,000	
	Discount on Issue of Debentures A/c	Dr.	3,000	
	To Debentures A/c			43,000
	(Being allotment money due on 1,000 debentures @ ₹ 40 each and discount @ ₹ 3 per debenture has been adjusted as per Board's Resolution No. . . . dated . . .)			
	Bank A/c	Dr.	40,000	
	To Debentures Allotment A/c			40,000
	(Being the allotment money received on 1,000 debentures @ ₹ 40 each)			
	Bank A/c	Dr.	14,100	
	To Calls-in-Advance A/c			14,100
	(Being the amount received in advance in respect of 300 debentures @ ₹ 47 each)			
	Debentures First Call A/c	Dr.	25,000	
	To Debentures A/c			25,000
	(Being first call money due on 1,000 debentures @ ₹ 25 each as per Board's Resolution No. ... dtd . ..)			
Sept. 30	Bank A/c	Dr.	17,500	
	Calls-in-Advance A/c	Dr.	7,500	
	To Debentures First Call A/c			25,000
	(Being the amount received on first call after adjustment of calls-in-advance @ ₹ 25 each on 300 debentures)			
	Debentures Final Call A/c	Dr.	22,000	
	To Debentures A/c			22,000
	(Being final call money due on 1,000 deb. @ ₹ 22 each as per Board's Res. No... dt ...)			
Nov. 30	Bank A/c	Dr.	15,400	
	Calls-in-Advance A/c	Dr.	6,600	
	To Debentures Final Call A/c			22,000
	(Being the amount received on final call after adjustment of calls-in-advance @ ₹ 22 each on 300 debentures)			
	Interest on Calls-in-Advance A/c (Note 1)	Dr.	345	
	To Bank A/c			345
	(Being interest on calls-in-advance paid @ 10% on ₹ 7,500 for 2 months and on ₹ 6,600 for 4 months)			

Working Notes : **(1) Calculation of Interest on Calls-in-Advance**

	₹
(a) ₹ 7,500 × 10% × 2/12	125
(b) ₹ 6,600 × 10% × 4/12	220
	345

Debenture Interest

Debenture interest is payable at regular intervals at a fixed percentage on the face value of the debenture. It is payable to the debentureholders whether profits are earned or not. The rate of interest paid by the company on its debentures depends on the following factors :

(i) the market rate of interest;
(ii) the security that the company agrees;
(iii) the terms of conversion into shares; and
(iv) the credit rating of the company.

Debenture interest is paid to debentureholders after deducting tax at source (where applicable).

Debenture interest is treated as operating expenses and it is charged to Profit and Loss Account.

Accounting Entries

(a) Debenture Interest Account Dr. [Gross interest]
To Debentureholders Account [Net amount]
To Tax Deducted at Source Account [Tax deducted]
(Being the interest payable to debentureholders after tax deducted at source).

(b) Debentureholders Account Dr.
To Bank Account
(Being interest paid to debentureholders)

Alternatively

Debenture Interest Account Dr.
To Bank Account
To Tax Deducted at Source Account

(c) Profit and Loss Account Dr.
To Debenture Interest Account

Tax deducted at source must be deposited to the Government (through prescribed banks) within a specified period. When it is deposited to the bank, the following entry is made :

Tax Deducted at Source Account Dr.
To Bank Account

Illustration 13

ABC Ltd issues 1,000, 14% debentures of ₹ 100 each at par on 1.1.2014. Under the terms of issue:

(a) Debenture interest is annually payable on 31st December every year; and
(b) 1/5th of the debentures are annually redeemable by drawings, the 1st redemption occurring on 31.12.2016.

Pass necessary journal entries for the year 2014 and 2015.

Solution

In the books of ABC Ltd
Journal

Date	Particulars		Dr. ₹	Cr. ₹
1.1.2014	Bank A/c	Dr.	1,00,000	
	To Debenture Application A/c			1,00,000
	(Being application money received for 1,000 debentures of ₹ 100 each)			
	Debenture Application A/c	Dr.	1,00,000	
	To 14% Debentures A/c			1,00,000
	(Being the allotment of 1,000 debentures of ₹ 100 each, as per Board's Resolution No. ... dated ...)			
31.12.2015	Debenture Interest A/c	Dr.	14,000	
	To Bank A/c			14,000
	(Being the debenture interest paid for the year)			
	Statement of Profit and Loss	Dr.	14,000	
	To Debenture Interest A/c			14,000
	(Being the debenture interest transferred to Profit and Loss Account)			
31.12.2016	Debenture Interest A/c	Dr.	14,000	
	To Bank A/c			14,000
	(Being the debenture interest paid for the year)			
	Statement of Profit and Loss	Dr.	14,000	
	To Debenture Interest A/c			14,000
	(Being the debenture interest transferred to Profit and Loss Account)			

Illustration 14

Lotus Ltd issued 2,000, 15% debentures of ₹ 100 each at a premium of 10% on 1st January, 2016. Under the terms of issue:

(a) Entire money is payable on application.
(b) Debenture interest is payable half-yearly on 30th June and 31st December.

(c) Tax to be deducted at source @ 10%.
(d) Debentures are to be redeemed after 5 years from the date of issue.
Pass necessary journal entries for the year 2016.

Solution **In the books of Lotus Ltd**
Journal

Date	Particulars		Dr. ₹	Cr. ₹
1.1.2016	Bank A/c	Dr.	2,20,000	
	To Debenture Application A/c			2,20,000
	(Being application money received for 2,000 debentures of ₹ 100 each, issued at a premium of 10%)			
	Debenture Application A/c	Dr.	2,20,000	
	To 15% Debentures A/c			2,00,000
	To Debenture Premium A/c			20,000
	(Being the allotment of 1,000 debentures of ₹ 100 each, as per Board's Resolution No. ... dated ...)			
30.6.2016	Debenture Interest A/c	Dr.	15,000	
	To Debentureholders A/c			13,500
	To Tax Deducted at Source A/c			1,500
	(Being the interest payable to debentureholders after tax deducted at source for 6 months)			
	Debentureholders A/c	Dr.	13,500	
	To Debenture Interest A/c			13,500
	(Being the debenture interest transferred to Profit and Loss Account)			
31.12.2016	Debenture Interest A/c	Dr.	14,000	
	To Bank A/c			14,000
	(Being the interest paid to debentureholders)			
	Tax Deducted at Source A/c	Dr.	1,500	
	To Bank A/c			1,500
	(Being the amount deposited from tax deducted at source)			
31.12.2016	Debenture Interest A/c	Dr.	15,000	
	To Debentureholders A/c			13,500
	To Tax Deducted at Source A/c			1,500
	(Being the interest payable to debentureholders after tax deducted at source for 6 months)			
	Debentureholders A/c	Dr.	13,500	
	To Bank A/c			13,500
	(Being the interest paid to debentureholders)			
	Tax Deducted at Source A/c	Dr.	1,500	
	To Bank A/c			1,500
	(Being the amount deposited for tax deducted at source)			
	Profit and Loss A/c (Note 1)	Dr.	30,000	
	To Debenture Interest A/c			30,000
	(Being the amount transferred to Profit and Loss Account)			

Tutorial Note : Debenture interest of the whole year is transferred to Profit and Loss Account at the end of the accounting year.

Debenture Stock

Debenture Stock is a document through which a large amount of loan is obtained by a company instead of issuing a number of debentures. The debenture stock may be repayable at a fixed date, may be secured or irredeemable depending upon the terms of the deed creating the debenture stock. Where there is a debenture stock there should be a debenture stock trust deed making provision for appointment of trustees. Debenture stock can be issued for any amount and may include fractions of a rupee.

Distinction between Debenture and Debenture Stock.

Debenture		Debenture Stock	
1.	It is the description of an instrument.	1.	It is the description of a debt or a sum secured by an instrument.
2.	It is always for a fixed sum (e.g., ₹ 100)	2.	It can be issued for any amount and may include fractions of a rupee.
3.	It is transferable only in its entirety.	3.	It is transferable in fragments subject to the provisions in the article to that effect.

Zero-interest Debenture These debentures carry a zero interest rate. These are offered at a large discount and later redeemed at par. The reward to the investor is the difference between these two amounts. The main advantage of these types of debentures is that the gain to the investor is not taxed as interest, but may be taxed as a capital gain. The advantage of the company is that there will be no cash outflow until the end of the life of the debentures.

Deep Discount Debentures These debentures carry a zero interest rate and are issued at a price very substantially below their redemption value. The reward of the investor is thus in the form of the difference between what is paid for the debentures at the time of issue and the amount that is receivable at the time when the debentures are redeemed.

Deep Gain Debentures These are similar to deep discount debentures. The only difference is that deep gain debentures are those which are redeemed at a large premium over their issue price.

Perpetual Debentures These debentures are issued by a company at a higher rate of interest but these debentures are ***never redeemed***. The main advantage of issuing these debentures is that the interest paid will qualify for deduction at the time of calculating the taxable income of the company. It is just like preference shares without the problem of redemption in future. In ***March 2013***, Tata Steel has issued perpetual debentures for ₹ 1,500 crore.

It is to be noted that in the Companies Act, 2013, there is no provision for issuing perpetual debentures. As per Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014, a company can issue secured and redeemable debentures only.

KEY POINTS

- According to Section 2 (30) of the Companies Act 2013, debentures includes debenture stock, bonds and any other instruments of a company evidencing a debt, whether constituting a charge on the assets of the company or not.
- '***Unsecured debentures***' will be treated as '***deposit***' and the Companies (Acceptance of Deposits) Rules, 2014 will be applicable.
- A company can issue only secured and redeemable debentures.
- As per the provision of Section 179(3)(c),the Board of Directors of a company has the power to issue debentures on behalf of the company. However, a resolution of the Board of Directors is to be passed in this respect.
- Where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.
- An issue of secured debentures may be made, provided the date of its redemption shall not exceed ***ten years*** from the date of issue.
- No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures.
- **Debenture Stock** is a document through which a large amount of loan is obtained by a company instead of issuing a number of debentures.
- **Zero-interest Debentures** carry a zero interest rate. These are offered at a large discount and later redeemed at par.
- **Deep Discount Debentures** carry a zero interest rate and are issued at a price very substantially below their redemption value.

THEORETICAL QUESTIONS

1. Define debenture as per the Companies Act, 2013.
2. State the factors to be taken into consideration for the issue of debentures.
3. What are the advantages and disadvantages of issue of debentures ?
4. What are the different types of debentures?
5. Give entries relating to the issue of debentures.
6. What do you mean by issue of debentures as collateral security for a loan? Give its accounting treatment.
7. What do you mean by 'naked debentures' ? State the treatment of this debenture as per the Comapnies Act, 2013.
8. State two conditions for appointment of a trustee.
9. Why debenture redemption reserve is created ?
10. What do you mean by retail investor for the purpose of issue of debentures ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Debentureholders are :
   A the owners of the company
   B the creditors of the company
   C the customers of the company
   D the vendors of the company
2. Debenture
   A can be forfeited for non-payment of calls money
   B cannot be forfeited for non-payment of calls money as per the provision of Section 71(12) of the Companies Act, 2013
   C can be forfeited under special circumstances
   D can be forfeited after taking Court permission
3. At the time of liquidation, debentureholders are paid off
   A after the shareholders
   B before the preferential creditors
   C before the shareholders
   D after the preferential creditors and shareholders
4. Debentures are shown in the company Balance Sheet under
   A Reserve and Surplus
   B Non-current Liabilities
   C Current Liabilities
   D Short-term Borrowings
5. 'Naked' debentures are
   A secured by a charge upon some or all assets of the company
   B not secured by any charge upon any assets
   C secured by a charge upon fixed assets of the company
   D secured by a charge upon current assets of the company
6. Interest on debentures are
   A the charges against profits
   B the appropriation of profits
   C not taken into consideration for calculating taxable income of the company
   D none of the above
7. As per the provision of the Companies Act, 2013, a company can issue
   A irredeemable debentures
   B unsecured debentures
   C secured redeemable debentures
   D unsecured but redeemable debentures

8. An issue of secured debentures may be made, provided its redemption shall not exceed
   A 5 year
   B 8 years
   C 10 years
   D 15 years
9. In case of public issue of debt securities
   A the credit rating is optional
   B the credit rating from at least two credit rating agencies are required
   C the credit rating from at least one credit rating agency is required
   D none of the above
10. The Debenture Redemption Reserve shall be created
   A out of capital profit only
   B out of securities premium account
   C out of the profit of the company available for payment of dividend
   D out of government grant

PRACTICAL QUESTIONS

Issue of Debentures

1. Show by means of Journal Entries how will you record the following issues. Also, show how they will appear in the respective Balance Sheets :
   (a) A Ltd. issues 10,000, 16% debentures of ₹ 100 each at a discount of 5%, redeemable at the end of 6 years at par.
   (b) B Ltd. issues 10,000, 14% debentures of ₹ 100 each at a discount of 5%, redeemable at the end of 5 years at a premium of 5%.
   (c) C Ltd. issues 10,000 15% debentures of ₹ 100 each at par, redeemable at the end of 5 years at a premium of 5%.
2. You are required to show the Journal Entries necessary to record the issue of 10,000, 12% Debentures of ₹ 100 each by X and Co. Ltd under the following cases separately: (i) at par and were also redeemable at par; (ii) at a discount of 5%, but were redeemable at par; (iii) at a premium of 5%, but were redeemable at par; and (iv) at a discount of 5%, but were redeemable at a premium of 5% and (v) At par, but were redeemable at a premium of 5%.
   Show also how the Debenture Account and the Accounts representing premium received on the issue of Debenture, premium payable on the redemption of debentures and losses incurred on the issue of debentures be shown in the Balance Sheet of the company (figures should be ignored, only the Account Headings should be shown in a single Balance Sheet).
3. A limited company made an issue of 10,000, 14% debentures of ₹ 100 each at par, which was fully subscribed. The debentures were allotted on July 31, 2016, subscription being payable 10% on application, 40% on allotment, 25% on September 30, 2016, and the balance on November 30, 2015.
   Under the terms of the issue, payment could be made in full on July 31, 2016. Interest on any such prepayment at the the rate of 12% p.a. Such interest is not deductible from the subscribers' payment, but is payable by the company on November 30, 2016.
   One allottee of 500 debentures took advantage of the prepayment terms, while others paid on the due dates.
   Journalise the entries to be made in the books of the company.
4. X Limited issued for subscription 5,000 debentures of ₹ 100 each at a discount of 3%. The whole of the issue offered was underwritten by Pal & Co., commission being 2.5% on nominal value. The public subscribed ₹ 4,00,000 worth of debentures balance being allotted to Pal & Co., who on subsequent date released their holdings in the market. The company took power to issue additional debentures worth ₹ 50,000 which were issued to its bank as collateral security against a loan of ₹ 40,000. Show the entries in the Cash Book and Ledger of the company and show how the entries would appear in the Balance Sheet. ***[C.A. (Inter) — Adapted]***
5. Journalise the transactions given below :
   (i) A debenture issued at ₹ 95 repayable at ₹ 100; (ii) A debenture issued at ₹ 95 repayable at ₹ 105; (iii) A debenture issued at ₹ 100 repayable at ₹ 105; (iv) A debenture issued at ₹ 105 repayable at ₹ 100.
   [Note : Face value of each debenture is ₹ 100]

Guide to Answers

Multiple Choice

1. B; 2. B; 3. C; 4. B; 5. B; 6. A; 7. C; 8. C; 9. C; 10. C.

7

Redemption of Debentures

Introduction

Debenture is the most common form of loan capital which is made available by investors on a long-term basis. It is a document containing details of an interest-bearing loan made to a company. In accounting parlance, debentures are referred to as long-term borrowings. It is a document which either creates a debt or acknowledges it. According to Section 2 (30) of the Companies Act 2015, debentures includes debenture stock, bonds and any other instruments of the company evidencing a debt, whether constituting a charge on the assets of the company or not.

A predetermined fixed rate of interest is payable on debentures (whether the company has earned any profit or not). Debentureholders are the creditors of the company, not the owners. They have no voting rights and cannot influence the management for the affairs of the company, but their claims for interest and for repayment of principal rank ahead of the claims of the shareholders.

Meaning of Redemption of Debentures

Redemption of debentures is a process of repayment of loan which was taken by issue of debentures. Most debentures are issued with the notice that they may be redeemed at the option of the company within a specified period and at a specified price. The terms of redemption are clearly mentioned in the debenture certificate. By the process of redemption, a company can adjust its capital structure.

Rules for Redemption of Debentures

Rule 18 of the Companies (Share Capital and Debenture) Rules, 2014 states that :

A company can issue ***secured debentures,*** provided the date of redemption shall not exceed ***10 years*** from the date of issue.

However, a company engaged in the setting up of infrastructure projects may issue secured debentures for a period exceeding ***ten years*** but not exceeding ***thirty years.***

It is clear from the above rules that the company will have to redeem the debentures within a certain period. Hence, it is important to note that the company must redeem the debentures in accordance with terms and conditions of their issue.

The provision of ***Section 71(10) and (11) of the Companies Act, 2013*** states that :

(1) Where a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all of the debentureholders, or debenture trustee and, after hearing the parties concerned, direct by order, the company to redeem the debentures forthwith on payment of principal and interest due thereon.

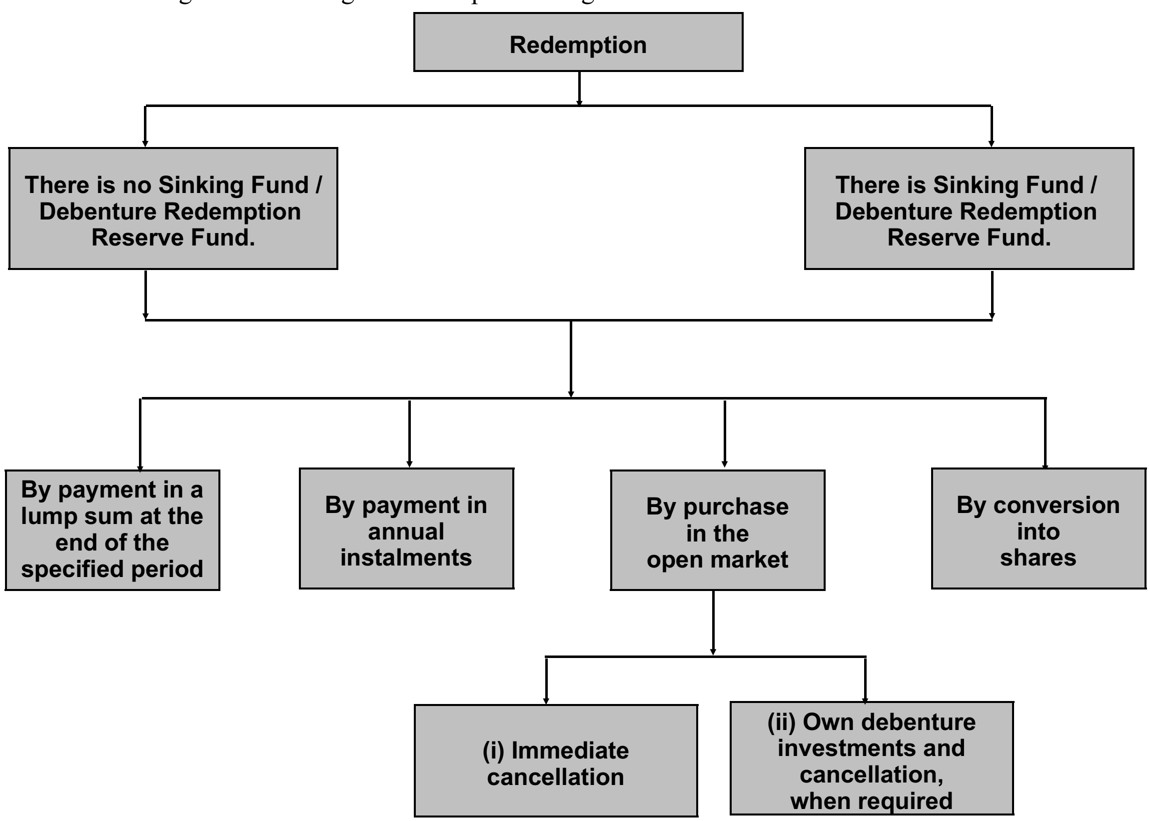
(2) If any default is made in complying with the order of the Tribunal under this section, every officer of the company who is in default shall be punished with imprisonment for a term which may extend to three years or with a fine which shall not be less than ₹ ***two lakh*** but which may extend to ₹ ***five lakh*** or ***with both***.

It is important to note that the provisions of the Companies Act, 2013 regarding the redemption of debentures are very strict. Therefore, every company chalks out the plan in advance for the redemption of the debentures.

Redemption of debentures may seriously affect the liquidity of the company. Keeping the date and mode of redemption in mind, every company divert some of the profits available to the shareholders towards a special fund (called Sinking Fund). Where the amount of debentures to be redeemed is small or it is to be redeemed by annual instalments, the company may not create any special fund. The accounting entries will differ according to the situations. We would like to discuss the accounting entries under two broad headings:

1. ***Where there is no Sinking Fund / Debenture Redemption Reserve Fund;***
2. ***Where there is Sinking Fund / Debenture Redemption Reserve Fund***.

The block diagram illustrating the whole process is given below:



1. Where there is no Sinking Fund / Debenture Redemption Reserve Fund

Sources of Redemption of Debentures

Debentures can be redeemed by utilising any of the following sources :

(a) From the proceeds of the fresh issue of share capital and on debentures;

(b) Out of profit.

(a) Redemption of Debentures from the Proceeds of Fresh Issue of Shares / Debentures

A company can issue new shares / debentures and the proceeds from such new issue can be used for redemption of old debentures. If new shares are issued for this purpose, the ***loan capital*** of the company will be replaced by the ***own capital***.

A company may prefer issue of new shares for the following reasons :

(i) The company has come to realise that the capital is needed permanently and it makes more sense to issue shares in place of debentures which carry a fixed rate of interest.

(ii) There is a boom in the primary market for shares.

(iii) The balance of profit, which would otherwise be available for dividend, is insufficient.

(iv) The liquidity position of the company is not good enough.

If new debentures are issued for this purpose, the ***old debentures*** will be replaced by the new debentures.

A company may prefer issue of new debentures when :

(i) company can issue fresh debentures by offering ***lower*** rate of interest.

(ii) the primary market for share is very dull.

(iii) the capital is not needed permanently.

(iv) the liquidity position of the company is not good enough.

(b) Redemption of Debenture out of Profit

As per Rule 18 of the Companies (Share Capital and Debenture) Rules 2014, the company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures. An adequate amount is to be transerred to Debenture Redemption Reserve out of profit of the company. It should be noted that after providing for DRR, divisible profits will go down. Hence, reward to shareholders would be diminished. However, after redemption of debentures, the balance of Debenture Redemption Reserve is transferred to ***General Reserve***.

Creation of Debenture Redemption Reserve

As per the Rule 18 of The Companies (Share Capital and Debentures) Rules 2014], the company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below-

(a) the Debenture Redemption Reserve shall be created out of the profits of the company ***available for payment of dividend***;

(b) the company shall create Debenture Redemption Reserve (DRR) in accordance with following conditions:-

  (i) No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures. For other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013, DRR will be as applicable to NBFCs registered with RBI.

  (ii) For NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997, 'the adequacy' of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008, and no DRR is required in the case of privately placed debentures.

  (iii) For other companies including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities), Regulations 2008 and also 25% DRR is required in the case of ***privately placed debentures by listed companies***. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of debentures.

(c) every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may ***be, a sum which shall not be less than fifteen percent***, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-
   (i) in deposits with any scheduled bank, free from any charge or lien;
   (ii) in unencumbered securities of the Central Government or of any State Government;
   (iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;
   (iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;
   (v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above:
   Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

Points to be Noted

- ***No DRR is required for debentures issued by All India Financial Institutions (AIFI).***
- ***DRR to the extent of 25% of the value of Debentures issued to be created by NBFCs registered with RBI. However, no DRR is required for privately placed debentures issued by the NBFCs.***
- ***All companies (except AIFI and NBFCs) will have to create DRR to the extent of 25% of the value of debentures issued.***

(d) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.

(e) the amount credited to the Debenture Redemption Reserve shall not be utilised by the company except for the purpose of redemption of debentures.

Rules for Creation of DRR at a Glance

Category of Companies	Nature of Issue of Debentures	DRR Percentage
All India Financial Institutions and Banking Companies	Public Issue	Nil
	Privately Placed	Nil
NBFCs and Other FI covered by Section 2(72) of the Companies Act, 2013	Public Issue	25%
	Privately Placed	Nil
Other Companies — Listed or Unlisted	Public Issue	25%
	Privately Placed	25%

Accounting Entries

(i) For transfer of amount to Debenture Redemption Reserve

Surplus / Statement of Profit and Loss Dr.
  To Debenture Redemption Reserve Account

(ii) For investment of DRR

Debenture Redemption Investment Account Dr.
  To Bank Account

(iii) For encashment of DRR Investment

Bank Account	Dr.	
Tax Deducted at Source Account	Dr.	
To Debenture Redemption Investment Account		
To Interest Earned Account		

(iv) For redemption of Debentures

(a) ***When debentures are redeemed at par***

(i) Debentures Account	Dr.	[Nominal value]	
To Debentureholders Account			
(ii) Debentureholders Account	Dr.		
To Bank Account			

(b) ***When debentures are redeemed at a premium***

(i) Debentures Account	Dr.	[Nominal value]	
Premium on Redemption of Debentures Account	Dr.	[Premium]	
To Debentureholders Account			[Total amount]
(ii) Debentureholders Account	Dr.		
To Bank Account			

(c) ***When debentures are redeemed at a discount***

(i) Debentures Account	Dr.	[Nominal value]	
To Debentureholders Account			[Actual amount]
To Profit on Redemption of Debentures Account		[Discount]	
(ii) Debentureholders Account	Dr.		
To Bank Account			

(v) For transfer to General Reserve

Debenture Redemption Reserve Account	Dr.	
To General Reserve Account		

Illustration 1

On 1 January, 2016, X Ltd issued 1,000, 12% Debentures of ₹ 100 each at par. These are repayable on 1st January, 2016 at par. X Ltd. transferred ₹ 25,000 to Debenture Redemption Reserve Account to comply with the provision of the Act. Interest is payable on 31st December every year. The accounting year closes on 31st December. (Ignore TDS)

You are required to pass necessary journal entries for the ***first year***.

Solution

In the books of X Ltd

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Bank A/c	Dr.		1,00,000	
Jan. 1	To Debentures Application A/c				1,00,000
	(Being the application money received on 1,000 debentures @ ₹ 100 each)				
?	Debentures Application A/c	Dr.		1,00,000	
	To 12% Debentures A/c				1,00,000
	(Being the allotment of 1,000, 12% debentures of ₹ 100 each as per Board's Resolution No. . . . dated . . .)				
Dec. 31	Debenture Interest A/c	Dr.		12,000	
	To Bank A/c				12,000
	(Being interest paid for the year)				
	Statement of Profit and Loss	Dr.		12,000	
	To Debenture Interest A/c				12,000
	(Being the interest on debentures transferred to Statement of Profit and Loss)				
	Statement of Profit and Loss	Dr.		25,000	
	To Debenture Redemption Reserve A/c				25,000
	(Being the necessary amount transferred to Debenture Redemption Reserve)				

Illustration 2

Ruchi Ltd. issued 42,000, 7% Debentures of ₹ 100 each on 1st April, 2011, redeemable at a premium of 8% on 31st March, 2017. The company decided to create required Debenture Redemption Reserve on 31st March, 2016. The company invested the funds as required by law in a fixed deposit with State Bank of India on 1st April, 2016 earning interest @ 10% per annum. Tax was deducted at source by the bank on interest @ 10%.

Pass necessary Journal Enqtries regarding issue and redemption of debentures..

Solution

In the books of Ruchi Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2011	**On Issue of Debentures**				
April 1	Bank A/c	Dr.		42,00,000	
	To Debentures Application A/c				42,00,000
	(Being the amount received on 42,000 debentures @ ₹ 100 each)				
April ?	Debentures Application A/c	Dr.		42,00,000	
	Loss on Issue of Debentures A/c	Dr.		3,36,000	
	To 7% Debentures A/c				42,00,000
	To Premium on Redemption of Debentures A/c				3,36,000
	(Being the allotment of 42,000, 7% Debentures of ₹ 100 each redeemable at a premium of 8% as per Board's Resolution No. . . . dated . . .)				

Tutorial Note : At the end of 2011-12, loss on issue of debentures will be written off by debiting Statement of Profit and Loss.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	**On Redemption of Debentures**				
March 31	Surplus, i.e., Balance in Statement of Profit and Loss	Dr.		10,50,000	
	To Debentures Redemption Reserve A/c				10,50,000
	(Being the creation of DRR to the extent of 25% of ₹ 42,00,000 as per the requirement of the Act)				
April 1	Debentures Redemption Investment A/c	Dr.		6,30,000	
	To Bank A/c				6,30,000
	(Being the investment made to the extent of 15% of ₹ 42,00,000 to comply with provision of the Companies Act. The rate of interest is 10%. p.a.)				
2017	Bank A/c	Dr.		6,86,700	
March 31	Tax Deducted at Source A/c	Dr.		6,300	
	To Debenture Redemption Investment A/c				6,30,000
	To Interest Received A/c				63,000
	(Being the encashment of investment for the purpose of redemption of debentures)				
	7% Debentures A/c	Dr.		42,00,000	
	Premium on Redemption of Debentures A/c	Dr.		3,36,000	
	To Debentureholders A/c				45,36,000
	(Being the amount payable on redemption, transferred to Debentureholders' Account)				
	Debentureholders A/c	Dr.		45,36,000	
	To Bank A/c				45,36,000
	(Being the amount paid to Debentureholders on redemption)				
	Debenture Redemption Reserve A/c	Dr.		10,50,000	
	To General Reserve a/c				10,50,000
	(Being the transfer of Debenture Redemption Reserve to General Reserve)				

Illustration 3

On 1st April, 2012, H Ltd. issued 50,000 10% Debentures of ₹ 100 each. Half of the debentures are due for redemption on 31st March, 2016. The Debenture Redemption Reserve stood at ₹ 11,00,000 on 31st March, 2015. The company created necessary Debenture Redmeption Reserve on 1st April, 2015. The company invested the necessary amount as required by law in a fixed deposit with Union Bank of India on 30th April, 2015 earning interest @ 8%. Tax was deducted at source @ 10% by the bank.

Pass necessary Journal Entries regarding redemption of debentures.

Solution

Half of the debentures are due for redemption on 31st March, 2016.

The required amount of DRR is equal to 25% of ₹ 50,00,000, i.e., ₹ 12,50,000.

Balance of DRR at present is ₹ 11,00,000. Therefore, the balance of ₹ 1,50,000 (12,50,000 – 11,00,000) DRR is to be created on 1st April, 2015.

Solution

In the books of H. ltd.
Journal

			Dr.	Cr.
2015 April 1	Surplus, i.e., Balance in Statement of Profit and Loss Dr. To Debentures Redemption Reserve A/c (Being the creation of DRR before the commencement of redemption of debentures)		1,50,000	1,50,000
April 30	Debentures Redemption Investment A/c Dr. To Bank A/c (Being the investment made in Fixed Deposit to the extent of 15% of ₹ 25,00,000 to comply with provision of the Companies Act.)		3,75,000	3,75,000
2016 March 31	Bank A/c Dr. Tax Deducted at Source A/c Dr. To Debenture Redemption Investment A/c To Interest Received A/c (Being the encashment of fixed deposit)		3,99,750 2,750	3,75,000 27,500
	10% Debentures A/c Dr. To Debentureholders A/c (Being the amount payable to debentureholders on redemption of 25,000 debentures of ₹ 100 each as per Board's Resolution No. ... dated ...)		25,00,000	25,00,000
	Debentureholders A/c Dr. To Bank A/c (Being the amount paid to Debentureholders on redemption)		25,00,000	25,00,000

Tutorial Note : Debenture Redemption Reserve will be transferred to General Reserve after the completion of all the redemption of debentures.

Methods of Redemption of Debentures

The debentures can be redeemed in one of the following ***four*** ways :

(a) In lump sum at the end of the stipulated period;
(b) By draw of lots;
(c) By purchasing in the open market;
(d) By conversion into new debentures or shares.

Payment in a Lump Sum at the End of a Specified Period

In this case, all debentures are redeemed at a time at the end of a specified period. The accounting entries are:

(a) When debentures are redeemed at par

(i) Debentures Account Dr.
To Debentureholders Account
(ii) Debentureholders Account Dr.
To Bank Account

(b) When debentures are redeemed at a premium

(i) Debentures Account Dr. [Nominal value]
Premium on Redemption of Debentures Account Dr. [Premium]
To Debentureholders Account
(ii) Debentureholders Account Dr.
To Bank Account

(c) When debentures are redeemed at a discount

(i) Debentures Account Dr. [Nominal value]
  To Debentureholders Account [Actual amount]
  To Profit on Redemption of Debentures Account [Discount]
(ii) Debentureholders Account Dr.
  To Bank Account

Payment in Annual Instalments

In this case, debentures to be redeemed are selected by lottery or drawings. The accounting entries are simple. When debentures are redeemed, Debentures Account is debited with the face value of debentures and Debentureholders Account is credited. On actual payment, Debentureholders Account is debited and Bank Account is credited. If the debentures are redeemed at a premium, the Debentureholders Account is credited with the premium and Premium on Redemption of Debentures Account is debited.

Accounting Entries

(a) When debentures are redeemed at par

(i) Debentures Account Dr. [Nominal value]
  To Debentureholders Account [Actual amount]
(ii) Debentureholders Account Dr. [Actual amount paid]
  To Bank Account

(b) When debentures are redeemed at a premium

(i) Debentures Account Dr. [Nominal value]
  Premium on Redemption of Debentures Account Dr. [Premium]
  To Debentureholders Account
(ii) Debentureholders Account Dr. [Actual amount paid]
  To Bank Account

(c) When debentures are redeemed at a discount

(i) Debentures Account Dr. [Nominal value]
  To Debentureholders Account [Actual amount]
  To Profit on Redemption of Debentures Account [Discount]
(ii) Debentureholders Account Dr.
  To Bank Account

In fact, premium paid on redemption is a loss. Generally, at the time of issue of debentures, a provision is made for the premium payable on redemption by debiting "Loss on Issue of Debentures Account" and crediting "Premium on Redemption Debentures Account". Till the date of redemption, it is shown on the Equity and Liabilities section of the Balance Sheet under 'Long-term Provisions'.

However, "loss on issue of debentures" is written-off against reserve and surplus.

Where no provision is made, Premium on Redemption of Debentures Account is closed by passing the following entry :

Debenture/Securities Premium Account Dr.
Statement of Profit and Loss Dr.
  To Premium on Redemption of Debentures Account

It should be noted that as a matter of financial prudence, an amount equal to the face value of debentures redeemed is transferred to General Reserve by debiting Statement of Profit and Loss (mind it, this is prudent, but not obligatory).

Illustration 4

XY Ltd., a NBFC registered with RBI, privately placed 2,000, 12% debentures of ₹ 100 each at par on 1st January 2012. Debentures are repayable at 5% premium in 5 equal annual instalments by lottery, the 1st redemption occurring on 31st December 2012.

Show 12% Debentures Account, Premium on Redemption of Debentures Account, Loss on Issue of Debentures Account, Debentureholders Account for all the years assuming that:

(i) the company's accounting year ending on 31st December;
(ii) all the terms of Debenture issue are duly complied with;
(iii) no DRR was created.

Solution

In the books of XY Limited

Dr. 12% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2012	To Debentureholders A/c	40,000	1.1.2012	By Bank A/c	2,00,000
31.12.2012	To Balance c/d	1,60,000			
		2,00,000			2,00,000
31.12.2013	To Debentureholders A/c	40,000	1.1.2013	By Balance b/d	1,60,000
31.12.2013	To Balance c/d	1,20,000			
		1,60,000			1,60,000
31.12.2014	To Debentureholders A/c	40,000	1.1.2014	By Balance b/d	1,20,000
31.12.2014	To Balance c/d	80,000			
		1,20,000			1,20,000
31.12.2015	To Debentureholders A/c	40,000	1.1.2015	By Balance b/d	80,000
31.12.2015	To Balance c/d	40,000			
		80,000			80,000
31.12.2016	To Debentureholders A/c	40,000	1.1.2016	By Balance b/d	40,000

Dr. Premium on Redemption of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2012	To Debentureholders A/c	2,000	1.1.2012	By Loss on Issue of Debentures A/c	10,000
31.12.2012	To Balance c/d	8,000			
		10,000			10,000
31.12.2013	To Debentureholders A/c	2,000	1.1.2013	By Balance b/d	8,000
31.12.2013	To Balance c/d	6,000			
		8,000			8,000
31.12.2014	To Debentureholders A/c	2,000	1.1.2014	By Balance b/d	6,000
31.12.2014	To Balance c/d	4,000			
		6,000			6,000
31.12.2015	To Debentureholders A/c	2,000	1.1.2015	By Balance b/d	4,000
31.12.2015	To Balance c/d	2,000			
		4,000			4,000
31.12.2016	To Debentureholders A/c	2,000	1.1.2016	By Balance b/d	2,000

Dr. Loss on Issue of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.1.2012	To Premium on Redemption A/c	10,000	31.12.2012	By Statement of Profit and Loss (Note 1)	10,000

Dr. Debentureholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2012	To Bank A/c	42,000	31.12.2012	By 12% Debentures A/c	40,000
			31.12.2012	By Premium on Redemption of Debentures A/c	2,000
		42,000			42,000
31.12.2013	To Bank A/c	42,000	31.12.2013	By 12% Debentures A/c	40,000
			31.12.2013	By Premium on Redemption of Debentures A/c	2,000
		42,000			42,000

31.12.2014	To Bank A/c	42,000	31.12.2014	By 12% Debentures A/c	40,000
			31.12.2014	By Premium on Redemption of Debentures A/c	2,000
		42,000			42,000
31.12.2015	To Bank A/c	42,000	31.12.2015	By 12% Debentures A/c	40,000
			31.12.2015	By Premium on Redemption of Debentures A/c	2,000
		42,000			42,000
31.12.2016	To Bank A/c	42,000	31.12.2016	By 12% Debentures A/c	40,000
			31.12.2016	By Premium on Redemption of Debentures A/c	2,000
		42,000			42,000

Debenture Market Price

The market price of a debenture is quoted as a percentage of its face value. A debenture selling at a market price greater than its face value is said to be selling at a premium; a debenture selling at a price below its face value is selling at a discount. Thus, a debenture quotation of 96 means the market price is 96% of face value, or at a discount; a debenture quotation of 104 means the market price is 104% of face value or at a premium.

The market price of a debenture constantly fluctuates since it raises with the safety of the investment. The primary factors which determine the market price of a debenture are :

(1) the relationship of the debentures interest rate to other investment opportunities;

(2) the length of time until the debenture matures; and

(3) investors' confidence in regard to company's strength to make all future payments of interest and principal amounts promptly.

These factors often result in a difference between the face value of a debenture and the price at which it can be purchased or sold in a stock exchange. As a debenture nears its maturity date, the market price of the debenture moves toward the maturity value.

Purchase in the Open Market

A company may redeem its debentures prior to maturity. The company may purchase its own debentures from stock market either: (i) for immediate cancellation, or (ii) as an investment (to be cancelled when required).

The principal reason for cancelling debentures before maturity date is to relieve the issuing company of the obligation to make future interest payments. If the debentures are listed in the stock market, they can be easily purchased and sold.

Generally, the company is interested to purchase its own debentures when the interest rate on the debentures is considerably higher than the current market interest rate.

The advantage of the company is that by issuing new debentures or by arranging loan at a lower interest rate, it can use the funds to reacquire the original, higher interest debentures.

When debentures are not listed on a stock exchange and issued ***privately***, the company may negotiate a price with the debentureholders to buy back the debentures for cancellation. Purchase of debentures in the open market prior to their maturity calls for the recognition of a gain or a loss for the difference between the amount paid and the face value of debentures. ***When the debentures are cancelled before maturity date, it calls for the cancellation of debenture face value***.

(i) Purchase of Debentures for Immediate Cancellation—on the Date of Interest

A Company may purchase its own debentures at any date for immediate cancellation. If the date of purchase of debentures and the date for payment of interest on debentures are the same, interest upto the date of purchase will be paid to the (old) debentureholders. The entries for purchase and cancellation of debentures will be as follows:

(a) When debentures are purchased

Debentures Redemption Account Dr. [Quoted price x No. of debentures purchased]

To Bank Account

(b) When debentures are cancelled

(i) Debentures Account Dr. [Face value]
 To Debentures Redemption Account [Purchase price]
 To Profit on Cancellation of Debentures Account [Profit]

(ii) If there is a loss on cancellation, it is transferred to Statement of Profit and Loss.
 Statement of Profit and Loss Dr. [Loss]
 To Debentures Redemption Account

(c) When profit on cancellation of debentures is transferred to Capital Reserve

Profit on Cancellation of Debentures Account Dr.
 To Capital Reserve Account*

*Profit on cancellation is a capital profit, it should be transferred to capital reserve.

(d) When face value of debentures is transferred to General Reserve

Statement of Profit and Loss Dr.
 To General Reserve Account

Illustration 5

On 1st January 2016, HP Ltd. had 10,000, 12% Debentures of ₹ 100 each. As per the provision of the deed, the directors acquired in the open market the following debentures for immediate cancellation: June 30, 2,000 debentures @ ₹ 98; December 31, 4,000 debentures @ ₹ 96. Debentures interest is payable half-yearly, on 30th June and 31st December.

Pass necessary Journal Entries (ignore interest and tax).

Solution

In the books of H. P. Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016 June 30	Debentures Redemption A/c (Note 1)	Dr.	1,96,000	
	To Bank A/c			1,96,000
	(Being the purchase of 2,000 debentures of ₹ 100 each @ ₹ 98 each for immediate cancellation)			
June 30	12% Debentures A/c	Dr.	2,00,000	
	To Debentures Redemption A/c			1,96,000
	To Profit on Cancellation of Debentures A/c			4,000
	(Being the cancellation of 2,000 debentures as per Board's Resolution No. ... dated ...)			
Dec. 31	Debentures Redemption A/c	Dr.	3,84,000	
	To Bank A/c			3,84,000
	(Being the purchase of 4,000 debentures of ₹ 100 each @ ₹ 96 each for immediate cancellation)			
Dec. 31	12% Debenture A/c	Dr.	4,00,000	
	To Debentures Redemption A/c			3,84,000
	To Profit on Cancellation of Debentures A/c			16,000
	(Being the cancellation of 4,000 debentures as per Board's Resolution No. ... dated ...)			
Dec. 31	Profit on Cancellation of Debentures A/c	Dr.	20,000	
	To Capital Reserve A/c (Note 2)			20,000
	(Being the profit on cancellation transferred to Capital Reserve)			
Dec. 31	Statement of Profit and Loss	Dr.	6,00,000	
	To General Reserve A/c			6,00,000
	(Being the amount equal to the face value of debentures redeemed transferred to general reserve)			

Tutorial Notes :

(1) Debentures Purchase Account can be debited in place of Debentures Redemption Account;

(2) Profit on cancellation of debentures is a **capital profit.** Therefore, it should be transferred to **Capital Reserve Account**;

(3) No entry is required to be passed for interest on debentures as per the requirement of the problem.

(ii) Purchase of Debentures for Immediate Cancellation — before the Date of Payment of Interest

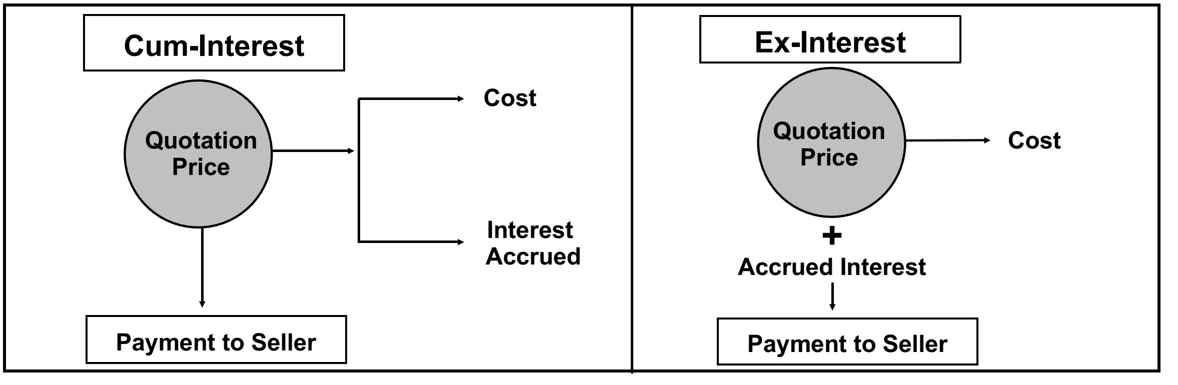
When debentures are purchased before the due date of interest, a problem may arise whether the quoted price includes interest upto the date of purchase or not. Price may be quoted ''Ex-interest" or ''Cum-interest''.

Meaning of Cum-interest and Ex-interest

'***Cum***' and '***Ex***' are *latin* words. '***Cum***' means with and '***Ex***' means without. The terms "Cum-interest" and "Ex-interest" relate to debentures and come up for consideration when debentures are purchased or sold. Cum-interest can be expanded as cumulative or inclusive of interest and Ex-interest can be expanded as exclusive of interest.

The quotation, Cum-interest, not only covers the cost but also includes the interest accrued upto the date of purchase; when interest becomes due, it would be the right of the buyer to claim that. Conversely, the quotation, Ex-interest, only covers the cost of the debentures and the buyer is liable to pay additional amount as interest accrued upto the date of purchase of debentures.

The block diagram illustrating the meaning of cum-interest and ex-interest is given in the next page.



In this connection, the following points are important:
(i) In respect of Government securities and debentures, the price quoted is Ex-interest unless otherwise stated; and (ii) In respect of Non-Government securities and debentures, it is Cum-interest unless otherwise stated.

When debentures are purchased Cum-interest, care must be taken at the time of passing entry for purchase of debentures. In this case, quotation price consists of ***cost plus accrued interest.*** Payment of accrued interest on debenture reacquisition is separately treated as a debit to debenture interest. Debentures Redemption Account will be debited with the cost price only and Debenture Interest Account will be debited with the accrued interest upto the date of purchase from the date of last interest paid. Bank Account will be credited with the quotation price. For calculating cost and accrued interest, the following steps should be followed :

Step 1 : Calculate the period between the date of last interest paid and the date of purchase of debentures.

Step 2 : Calculate accrued interest by applying the following formula:

$$\frac{\text{Rate of interest} \times \text{Period (in month)}}{12} \times \text{Face value of debentures purchased}$$

Step 3 : Calculate cost as follows :

(Quotation price × No. of debentures purchased) *less* Accrued interest as calculated in Step 2

Example: On 1st April, 2017, X Ltd purchased 2,000, 12% debentures of ₹ 100 each @ ₹ 98 (cum- interest). Debenture interest is payable half-yearly, on 30th June and 31st December. Date of closing the books of account is 31st December every year. Cost and accrued interest is to be calculated as follows :

Step 1 : Calculation of period (in months) From 1.1.2017 to 31.3.2017 = 3 months.

Step 2 : Accrued interest = 12% x 3/12 x ₹ 2,00,000 = ₹ 6,000.

Step 3 : Cost = (₹ 98 x 2,000) *Less* ₹ 6,000 = ₹ 1,90,000.

The entry for purchase will be as follows :

Debentures Redemption Account	Dr.	₹ 1,90,000	
Debenture Interest Account	Dr.	₹ 6,000	
To Bank Account (₹ 98 x 2,000)			₹ 1,96,000

(Being purchase of 2,000, 12% Debentures @ ₹ 98 Cum-interest for cancellation)

When debentures are purchased Ex-interest, the Debentures Redemption Account will be debited with quotation price (which is, in fact, nothing but the cost price) and Debenture Interest Account will be debited with accrued interest. Bank Account will be credited with the quotation price *plus* accrued interest.

In the above example, let us assume that, debentures were purchased @ ₹ 98 (Ex-interest).

In such a situation, the entry for purchase of debentures will be as follows :

Debentures Redemption Account	Dr.	₹ 1,96,000	
Debenture Interest Account	Dr.	₹ 6,000	
To Bank Account			₹ 2,02,000

(Being the purchase of 2,000, 12% debentures @ ₹ 98 ex-interest for cancellation)

Accounting Entries

(a) When debentures are purchased

Debentures Redemption Account	Dr.	[Cost]
Debenture Interest Account	Dr.	[Accrued interest]
To Bank Account		[Total payment]

(b) When debentures are cancelled

(i) Debentures Account	Dr.	[Face value]
To Debentures Redemption Account		[Cost]
To Profit on Cancellation of Debentures Account		[Profit]

(ii) Loss on cancellation is transferred to Statement of Profit and Loss.

Statement of Profit and Loss Dr.

To Debentures Redemption Account

(c) When profit on cancellation of debentures is transferred to Capital Reserve

Profit on Cancellation of Debentures Account Dr.

To Capital Reserve Account

(d) When face value of debentures is transferred to General Reserve

Statement of Profit and Loss Dr.

To General Reserve Account

Illustration 6

On 1.3.2017, PQR Ltd. purchases its own 6% debentures, of ₹ 10,000 @ ₹ 96 Cum-interest and cancels immediately, interest on debentures being payable on June 30 and December 31 each year. Pass journal entries.

Solution

In the books of PQR Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017	Debentures Redemption A/c (Note 1)	Dr.	9,500	
March 1	Debenture Interest A/c	Dr.	100	
	To Bank A/c			9,600
	(Being the purchase of 100 debentures @ ₹ 96 cum-interest for immediate cancellation)			
March 1	6% Debentures A/c	Dr.	10,000	
	To Debentures Redemption A/c			9,500
	To Profit & Loss on Cancellation of Debentures A/c*			500
	(Being the cancellation of 100 debentures)			

*At the year end, profit on cancellation is transferred to Capital Reserve Account, being capital profit.

Working Note: (1) When debentures are purchased "Cum-interest", accrued interest upto the date of purchase is calculated and deducted from quoted price. The net amount is debited to Debentures Redemption Account. Here, total purchase price is ₹ 9,600 and interest upto the date of purchase is (₹ 10,000 x 6/100 x 2/12) = ₹ 100. Therefore (₹ 9,600 – ₹ 100) = ₹ 9,500 is to be debited to Debentures Redemption Account.

Students should remember that profit or loss on redemption of debentures arises only on cancellation or sale.

Illustration 7

On 1st January 2016, Nelco Ltd. had outstanding in its books 1,000, 12% Debentures of ₹ 100 each. The interest is payable on 30th June and 31st December every year. In accordance with the power in the deed, the directors acquired in the open market Debentures for immediate cancellation as follows :

2016 March 1 ₹ 10,000 @ ₹ 98.00 (cum-interest); 2016 Aug.1 ₹ 20,000 @ ₹ 100.25 (cum-interest);
2016 Nov.1 ₹ 5,000 @ ₹ 98.50 (ex-interest).

Pass necessary Journal Entries in the books of the company, ignoring brokerage and income tax.

Solution

In the books of Nelco Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016	Debentures Redemption A/c (Note 1)	Dr.	9,600	
March 1	Debenture Interest A/c	Dr.	200	
	To Bank A/c			9,800
	(Being the purchase of 100, 12% Debentures @ ₹ 98 each Cum-interest for immediate cancellation)			
	12% Debentures A/c	Dr.	10,000	
	To Debentures Redemption A/c			9,600
	To Profit & Loss on Cancellation of Debentures A/c			400
	(Being the cancellation of 100, 12% debentures and the profit on cancellation of debentures transferred to Profit & Loss on Cancellation of Debentures Account)			
June 30	Debenture Interest A/c	Dr.	5,400	
	To Bank A/c			5,400
	(Being the interest paid on 900 debentures @ 12% p.a. for 6 months ending on 30th June)			
Aug. 1	Debentures Redemption A/c (Note 2)	Dr.	19,850	
	Debenture Interest A/c	Dr.	200	
	To Bank A/c			20,050
	(Being the purchase of 200, 12% debentures @ ₹ 100.25 Cum-interest for immediate cancellation)			
	12% Debentures A/c	Dr.	20,000	
	To Debentures Redemption A/c			19,850
	To Profit & Loss on Cancellation of Debentures A/c			150
	(Being the cancellation of 200, 12% Debentures and profit on cancellation is transferred to Profit & Loss on Cancellation of Debentures Account)			
Nov. 1	Debentures Redemption A/c (Note 3)	Dr.	4,925	
	Debenture Interest A/c	Dr.	200	
	To Bank A/c			5,125
	(Being the purchase of 50, 12% Debentures @ ₹ 98.50 ex-interest for immediate cancellation)			
	12% Debentures A/c	Dr.	5,000	
	To Debentures Redemption A/c			4,925
	To Profit & Loss on Cancellation of Debentures A/c			75
	(Being the cancellation of 50, 12% Debentures and the profit on cancellation is transferred to Profit & Loss on Cancellation of Debentures Account)			
Dec. 31	Debenture Interest A/c	Dr.	3,900	
	To Bank A/c			3,900
	(Being the interest paid on 650 debentures @ 12% p.a. for 6 months ending on December 31)			
Dec. 31	Statement of Profit and Loss	Dr.	9,900	
	To Debenture Interest A/c			9,900
	(Being the interest on debentures for the year transferred to Statement of Profit and Loss)			
Dec. 31	Statement of Profit and Loss	Dr.	35,000	
	To General Reserve A/c			35,000
	(Being the nominal value of debentures redeemed during the year transferred to General Reserve A/c)			
Dec. 31	Profit & Loss on Cancellation of Debentures A/c	Dr.	625	
	To Capital Reserve A/c			625
	(Being the profit on cancellation transferred to Capital Reserve Account)			

Working Notes :

(1) 100 debentures have been purchased @ ₹ 98 cum-interest on 1st March. This price of ₹ 98 includes interest for the month of January and February. Therefore, ₹ 200 interest (₹ 10,000 x 2/12 x 12/100) is to be deducted from the total amount paid in respect of 100 debentures. The net amount (₹ 9,800 – ₹ 200) = ₹ 9,600 is to be debited to Debentures Redemption Account.

(2) 200 debentures have been purchased @ ₹ 100.25 cum interest on 1st August . This price of ₹ 100.25 includes interest for the month of July. Therefore, ₹ 200 interest (₹ 20,000 x 1/12 x 12/100) is to be deducted from the total amount paid in respect of 200 debentures. The net amount (₹ 20,050 – ₹ 200) = ₹ 19,850 is to be debited to Debentures Redemption Account

(3) If the debentures are purchased ex-interest, the interest to the date of transaction is paid, in addition to quoted price. Debentures Redemption Account is to be debited with (₹ 50 x ₹ 98.50) = ₹ 4,925.

Illustration 8

Indebted Ltd., issued 10% Debentures at par for ₹ 8,00,000 on 1st January, 2011. Interest was payable half yearly on 30th June and 31st December every year. Under the terms of the trust deed, the debentures are redeemable at par (after three years of issue) by the company purchasing them in the open market and cancelling them with a minimum redemption of ₹ 80,000 every year. In case, there was a shortfall in redemption by the company by open market operations, the shortfall would be made good by the company by payment on the last day of the accounting year to the trustees who would draw lots and redeem the debentures.

The company purchased its own debentures for cancellation as follows :

(a) 30th September 2014 ₹ 1,00,000 at ₹ 98 cum-interest;

(b) 31st May 2015 ₹ 60,000 at ₹ 95 ex-interest;

(c) 31st July, 2016 ₹ 90,000 at ₹ 96 cum-interest.

The company carried out its obligations under the deed.

Prepare the following Ledger Accounts for calendar years 2014, 2015 and 2016:

(i) 10% Debentures Account;

(ii) Debentures Redemption Account; and (iii) Debenture Interest Account (ignore taxation).

Solution

In the books of Indebted Ltd.

10% Debentures Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
30.9.2014	To Debentures Redemption A/c	95,500	1.1.2014	By Balance b/d	8,00,000
30.9.2014	To P/L on Canc. of Debentures A/c*	4,500			
31.12.2014	To Balance c/d	7,00,000			
		8,00,000			8,00,000
31.5.2015	To Debentures Redemption A/c	57,000	1.1.2015	By Balance b/d	7,00,000
31.5.2015	To P/L on Canc. of Debentures A/c*	3,000			
31.12.2015	To Debentures Redemption A/c	20,000			
31.12.2015	To Balance c/d	6,20,000			
		7,00,000			7,00,000
31.7.2016	To Debentures Redemption A/c	85,650	1.1.2016	By Balance b/d	6,20,000
31.7.2016	To P/L on Canc. of Debentures A/c*	4,350			
31.12.2016	To Balance c/d	5,30,000			
		6,20,000			6,20,000

* The balances of Profit and Loss on Cancellation of Debentures Account is transferred to Capital Reserve at the year end.

Debentures Redemption Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
30.9.2014	To Bank A/c	95,500	30.9.2014	By 10% Debentures A/c	95,500
31.5.2015	To Bank A/c	57,000	31.5.2015	By 10% Debentures A/c	57,000
31.12.2015	To Bank A/c	20,000	31.12.2015	By 10% Debentures A/c	20,000
		77,000			77,000
9.7.2016	To Bank A/c	85,650	31.7.2016	By 10% Debentures A/c	85,650

Debenture Interest Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
30.6.2014	To Bank A/c	40,000	31.12.2014	By Statement of Profit and Loss	77,500
30.9.2014	To Bank A/c	2,500			
31.12.2014	To Bank A/c	35,000			
		77,500			77,500

31.5.2015	To Bank A/c	2,500	31.12.2015	By Statement of Profit and Loss	66,500
30.6.2015	To Bank A/c	32,000			
31.12.2015	To Bank A/c	32,000			
		66,500			66,500
30.6.2016	To Bank A/c	31,000	31.12.2016	By Statement of Profit and Loss	58,250
31.7.2016	To Bank A/c	750			
31.12.2016	To Bank A/c	26,500			
		58,250			58,250

Working Notes: **(1) Calculation of Interest on Debentures @ 10% p.a.**

Date	Amount of Debentures (₹)	Period (Months)	Amount of interest (₹)	Total (₹)
30.6.2014	8,00,000	6	40,000	
30.9.2014	1,00,000	3	2,500	
31.12.2014	7,00,000	6	35,000	77,500
31.5.2015	60,000	5	2,500	
30.5.2015	6,40,000	6	32,000	
31.12.2015	6,40,000	6	32,000	66,500
30.6.2016	6,20,000	6	31,000	
31.7.2016	90,000	1	750	
31.12.2016	5,30,000	6	26,500	58,250

(i) Purchase of Debentures as Investment — on the Date of Interest

A company may purchase its own debentures ***as investment***. Such debentures are kept alive. In future, it can be sold in the market again or it will be cancelled. When own debentures are purchased as investment, an account called ''Investment in Own Debentures Account'' or ''Own Debentures Account'' is debited with the quotation price and Bank Account is credited with the same amount. ''Investment in Own Debentures Account'' is shown on the assets side of the ***Balance Sheet under the heading "Investment".***

Interest on own debentures of the post-purchase period is credited to Statement of Profit and Loss just like any other income from other investments. Debenture Interest Account is debited with the total interest (payable to outside debentureholders plus interest on own debentures held as investment).

The accounting entries will be as follows:

(a) When debentures are purchased

Investment in Own Debentures Account	Dr.	[Quotation price x No. of debentures purchased]
To Bank Account		
(Being the purchase of .... debentures @ ₹ ..... each as investment)		

(b) When interest on debentures is due and paid

Debenture Interest Account	Dr.	[Total interest]
To Bank Account		[Interest paid to outside debentureholders]
To Interest on Own Debentures Account		[Own Debentures]
(Being the interest on debenture paid and adjusted)		

(c) When debentures are cancelled

Debentures Account	Dr.	[Face value]
To Investment in Own Debentures Account		[Purchase price]
To Profit on Cancellation of Debentures Account		[Profit]
(Being the cancellation of .... debentures)		

(d) When profit on cancellation of debentures is transferred to Capital Reserve

Profit on Cancellation of Debentures Account	Dr.
To Capital Reserve Account	
(Being profit on cancellation is transferred to Capital Reserve Account)	

(e) When face value of debentures is transferred to General Reserve

Profit & Loss Account	Dr.
To General Reserve Account	
(Being the amount equal to the face value of debentures redeemed is transferred to general reserve)	

(f) When interest on own debentures is transferred

Interest on Own Debentures Account Dr.
To Statement of Profit and Loss
(Being the interest on own debentures is transferred to Statement of Profit and Loss)

(g) When debentures interest (paid during the year) is transferred to Statement of Profit and Loss

Statement of Profit and Loss Dr.
To Debenture Interest Account
(Being interest charged to Statement of Profit and Loss)

Treatment of Interest on Own Debentures

When debentures are purchased as investment, the interest of the post-purchase period is calculated and credited to ''Interest on Own Debentures Account''. Debenture Interest Account is debited with the full interest (whether held by the company or outsiders). At the end of the accounting period, Statement of Profit and Loss is debited with the full amount of ''Debenture Interest'' and credited with the ''Interest on Own Debentures''.

Illustration 9

On 1st January 2016, XY Ltd. had 5,000, 12% Debentures of ₹ 100 each. The company purchased in the open market 1,000 debentures @ ₹ 96 each on 30th June 2016. Debenture interest is payable half yearly, on 30th June and 31st December. The Company cancelled all the purchased debentures on 31st December 2016.

Pass necessary Journal Entries (ignore brokerage and income-tax).

Solution

In the books of XY Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016 June 30	Debenture Interest A/c	Dr.	30,000	
	To Bank A/c			30,000
	(Being the interest paid on outstanding 5,000 debentures for 6 months)			
June 30	Investment in Own Debentures A/c	Dr.	96,000	
	To Bank A/c			96,000
	(Being the purchase of 1,000 debentures @ ₹ 96 each as investments)			
Dec. 31	Debenture Interest A/c	Dr.	30,000	
	To Bank A/c			24,000
	To Interest on Own Debentures A/c			6,000
	(Being the interest on 4,000 debentures paid in cash to outside debentureholders and interest on 1,000 debentures transferred to Interest on Own Debentures Account)			
Dec. 31	Statement of Profit and Loss	Dr.	60,000	
	To Debenture Interest A/c			60,000
	(Being the debenture interest transferred to Statement of Profit and Loss)			
Dec. 31	Interest on Own Debentures A/c	Dr.	6,000	
	To Statement of Profit and Loss			6,000
	(Being the interest on own debentures credited to Statement of Profit and Loss)			
Dec. 31	12% Debentures A/c	Dr.	1,00,000	
	To Investment in Own Debentures A/c			96,000
	To Profit and Loss on Cancellation of Debentures A/c			4,000
	(Being the cancellation of 1,000 debentures purchased on 30.6.1997)			
Dec. 31	Profit and Loss on Cancellation of Debentures A/c	Dr.	4,000	
	To Capital Reserve A/c			4,000
	(Being the profit on cancellation of debentures transferred to capital reserve)			
Dec. 31	Statement of Profit and Loss	Dr.	1,00,000	
	To General Reserve A/c			1,00,000
	(Being the amount equal to face value of the debentures redeemed transferred to general reserve)			

(ii) Purchase of Debentures as Investment — before the Date of Payment of Interest

When debentures are purchased before the date of payment of interest, Investment in Own Debentures Account is debited with the cost (which is determined in the same manner as we do in case of purchase of debentures for immediate cancellation). Debenture Interest Account is also debited with the amount of accrued interest upto the date of purchase from the date of last payment of interest. The Bank Account is credited with the amount paid to the seller of debentures.

Interest on own debentures of the post-purchase period is credited to Statement of Profit and Loss. Until cancellation, Investment in Own Debentures is shown in the Balance Sheet under the heading ''Investments''.

Accounting Entries :

(a) When debentures are purchased

Investment in Own Debentures Account	Dr. [Cost]
Debenture Interest Account	Dr. [Accrued interest]
To Bank Account	[Total payment]

(b) When interest on debenture is due and paid

Debenture Interest Account	Dr. [Total interest – interest paid during purchase]
To Bank Account	[Interest paid to outside Debentureholders]
To Interest on Own Debentures Account	[Own Debentures]

(c) When debentures are cancelled

(i) Debentures Account	Dr. [Face value]
To Investment in Own Debentures Account	[Cost]
To Profit and Loss on Cancellation of Debentures Account	[Profit]
(ii) Loss on cancellation is debited to Profit & Loss Account	
Statement of Profit and Loss	Dr.
To Profit and Loss on Cancellation of Debentures Account	

(d) When debentures are sold without cancelling

(i) Bank Account	Dr. [Sale proceeds]
To Investment in Own Debentures Account	[Cost]
To Profit on Sale of Own Debentures Account	[Profit]
(ii) Loss on sale is debited to Statement of Profit and Loss	
Statement of Profit and Loss	Dr.
To Loss on Sale of Own Debentures Account	

(e) When profit on cancellation of debentures is transferred to Capital Reserve

Profit on Cancellation of Debentures Account	Dr.
To Capital Reserve Account	

(f) When face value of debentures is transferred to General Reserve

Statement of Profit and Loss	Dr.
To General Reserve Account	

(g) When interest on own debentures is transferred to Statement of Profit and Loss

Interest on Own Debentures Account	Dr.
To Statement of Profit and Loss	

(h) When debenture interest (paid for the year) is transferred to Statement of Profit and Loss

Statement of Profit and Loss	Dr.
To Debenture Interest Account	

Illustration 10

A Ltd. has issued 1,000, 6% Debentures of ₹ 100 each. The company on 1st March, 2016 purchased 50 of its debentures at ₹ 96 each cum-interest (interest payable on 30th June and 31st December). These debentures are cancelled on 31st December, 2016, the date of year ending.

Show the Journal entries to record the above transactions.

Solution

In the books of A Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016	Investment in Own Debentures A/c	Dr.	4,750	
March 1	Debenture Interest A/c (Note 1)	Dr.	50	
	To Bank A/c			4,800
	(Being the purchase of 50 debentures of ₹ 100 each @ ₹ 96 cum-interest)			
June 30	Debenture Interest A/c (Note 2)	Dr.	2,950	
	To Bank A/c			2,850
	To Interest on Own Debentures A/c			100
	(Being the interest on 950 debentures @ 6% for 6 months paid and interest on 50 own debentures credited to Interest on Own Debentures Account)			
Dec. 31	Debenture Interest A/c	Dr.	3,000	
	To Bank A/c			2,850
	To Interest on Own Debentures A/c			150
	(Being the interest on 950 debentures @ 6% for 6 months paid and interest on 50 own debentures credited to Interest on Own Debentures Account)			
Dec. 31	6% Debentures A/c	Dr.	5,000	
	To Investment in Own Debentures A/c			4,750
	To Profit on Cancellation of Debentures A/c			250
	(Being the cancellation of 50 debentures purchased on 1st March, 2016)			
Dec. 31	Profit on Cancellation of Debentures A/c	Dr.	250	
	To Capital Reserve A/c			250
	(Being the profit on cancellation of debentures transferred to Capital Reserve Account)			
Dec. 31	Statement of Profit and Loss	Dr.	6,000	
	To Debenture Interest A/c			6,000
	(Being the debenture interest transferred to Statement of Profit and Loss)			
Dec. 31	Interest on Own Debentures A/c	Dr.	250	
	To Statement of Profit and Loss			250
	(Being the interest on own debentures credited to Statement of Profit and Loss)			
Dec. 31	Statement of Profit and Loss	Dr.	5,000	
	To General Reserve A/c			5,000
	(Being the amount equal to the face value of debentures cancelled transferred to General Reserve)			

Working Notes : (1) Accrued interest = 6% x 2/12 x ₹ 5000 = ₹ 50 **(2)** Actual interest for 6 months comes to ₹ 3,000 but ₹ 50 was already paid on March 1 when 50 debentures were purchased.

Illustration 11

Draft journal entries in respect of the following since March 1, 2016: In 2010 XY Ltd had issued 5,000, 7.5% Debentures of ₹ 100 each. On 1st March, 2016, the company purchased 500 of its own 7.5% Debentures at ₹ 47,500 cum-interest.

The debentures were held as investment until 30th June, 2016 when it was decided to cancel them. Interest is payable half yearly on 30th June and 31st December and the books are closed on 30th June each year. Assume absence of sinking fund.

[I.C.W.A. (Inter) — Adapted]

Solution

In the books of XY Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016	Investment in Own Debentures A/c (Note 1)	Dr.	46,875	
March 1	Debenture Interest A/c	Dr.	625	
	To Bank A/c			47,500
	(Being the purchase of 500 debentures for ₹ 47,500 cum-interest which will be held as investment)			
June 30	Debenture Interest A/c (Note 2)	Dr.	16,875	
	To Bank A/c			16,875
	(Being interest paid to outside debentureholders for 4,500 debentures for 6 months)			
June 30	Debenture Interest A/c	Dr.	1,250	
	To Interest on Own Debentures A/c			1,250
	(Being adjustment for interest on 500 own debentures for 4 months)			
June 30	7.5% Debentures A/c	Dr.	50,000	
	To Investment in Own Debentures A/c			46,875
	To Profit on Cancellation of Debentures A/c			3,125
	(Being cancellation of 500 own debentures)			

June 30	Profit on Cancellation of Debentures A/c Dr. To Capital Reserve A/c (Being profit on cancellation of debentures transferred to capital reserve)	3,125	3,125
June 30	Statement of Profit and Loss Dr. To Debenture Interest A/c (Being debenture's interest transferred to Statement of Profit and Loss)	3,750	3,750
June 30	Interest on Own Debentures A/c Dr. To Statement of Profit and Loss (Being interest on own debentures transferred to Statement of Profit and Loss)	1,250	1,250
June 30	Statement of Profit and Loss Dr. To General Reserve A/c (Being the amount equal to the face value of debentures transferred to general reserve)	50,000	50,000

Working Notes :

(1) Total amount paid ₹ 47,500; *Less* Interest for 2 months ₹ 625. Therefore, amount to be debited to Own Debentures Account = ₹ 46,875.

(2) Interest payable to outside Debentureholders = ₹ 4,50,000 x 7.5/100 x 1/2 = ₹ 16,875.

Illustration 12

Rama Limited issued 8% Debentures of ₹ 3,00,000 in earlier year on which interest is payable half yearly on 31st March and 30th September. the company has power to purchase its own debentures in the open market for cancellation thereof. The following purchases were made during the financial year 2010-11 and cancellation made on 31st March, 2011.

(a) On 1st April, ₹ 50,000 nominal value debentures purchased for ₹ 49,450, ex-interest.

(b) On 1st September, ₹ 30,000 nominal value debentures purchased for ₹ 30,250 cum-interest.

Show the Journal Entries for the transactions held in the year 2010-11. ***[C.A. (IPCC) — November, 2011]***

Solution

In the books of Rama Ltd
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2010 April 1	Investment in Own Debentures A/c Dr. To Bank A/c (Being purchase of 500 own debentures as investment)	49,450	49,450
Sept 1	Investment in Own Debentures A/c Dr. Debenture Interest A/c (Note 1) Dr. To Bank A/c (Being purchase of 300 own debentures as investment—cum-interest)	29,250 1,000	30,250
Sept 30	Debenture Interest A/c Dr. To Bank A/c To Interest on Own Debentures A/c (Being interest on debentures paid to outside debentureholders and interest on own debentures credited to Interest on Own Debenture Account)	11,000	8,800 2,200
2011 Mar 31	Debenture Interest A/c Dr. To Bank A/c To Interest on Own Debentures A/c (Being interest on 2,200 debentures @ 8% for 6 months paid to outside debentureholders. Interest on 800 debentures adjusted with Own Debenture Interest Account)	12,000	8,800 3,200
	8% Debentures A/c Dr. To Investment in Own Debentures A/c To Profit on Cancellation of Debentures A/c (Being the cancellation of 800 debentures of ₹ 100 each)	80,000	78,700 1,300
	Statement of Profit and Loss Dr. To Debenture Interest A/c (Being the interest on debentures transferred to Statement of Profit and Loss)	24,000	24,000
	Interest on Own Debentures A/c (₹ 2,200 + 3,200) Dr. To Statement of Profit and Loss (Being interest on own debentures credited to Statement of Profit and Loss)	5,400	5,400
	Profit on Cancellation of Debentures A/c Dr. To Capital Reserve A/c (Being profit on cancellation of debentures transferred to Capital Reserve Account)	1,300	1,300

	Statement of Profit and Loss Dr. To General Reserve A/c (Being the amount transferred to General Reserve Account)	80,000	80,000

Working Notes :

(1) Accrued Interest = 30,000 $\times \frac{8}{100} \times \frac{5}{12}$ = ₹ 1,000.

(2) Calculation of Interest Payable on 30th September, 2014 :

(i) Debentures held by the outsiders = 2,200.

Interest payable to outside debentureholders = 2,20,000 $\times \frac{8}{100} \times \frac{1}{2}$ = ₹ 8,800.

(ii) Debentures held as investment : 800.

(a) Interest on debentures purchased on 1st April = 50,000 $\times \frac{8}{100} \times \frac{1}{2}$ = ₹ 2,000

(b) Interest on debentures purchased on 1st September = 30,000 $\times \frac{8}{100} \times \frac{1}{12}$ = ₹ 200

Illustration 13

On 1.1.2011 L.F. Industries Co. Ltd. issued 20,000, 10% Debentures of ₹ 100 each at par. On 7.1.2011, application money of ₹ 50 per debenture and after one month, the balance money were received.

On 1.1.2013, the company purchased from open market 5,000 own debentures at ₹ 102 and cancelled them.

On 1.1.2014, the company redeemed 2,000 debentures at par by annual drawings.

On 1.1.2015, the company purchased 8,000 own debentures from open market @ ₹ 98 and held them as investment.

On 1.1.2016, the company cancelled its own debentures and redeemed the remaining debentures at a premium of 5%. The balance of Statement of Profit and Loss on that day was ₹ 1,00,000. Show all Journal Entries from issue to redemption.

Solution

Some vital information has not been provided in the question. Therefore, we assume the following :

(1) Interest on debenture is payable annually on 31st December every year.

(2) The financial year of the company ending on 31st December.

(3) In 2011, interest was paid for full year.

In the books of L.F. Industries Co. Ltd.
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2011 Jan.7	Bank A/c Dr. To 10% Debentures Application A/c (Being the debenture application money received on 20,000, 10% Debentures of ₹ 100 each — @ ₹ 50 per debenture)	10,00,000	10,00,000
?	10% Debentures Application A/c Dr. To 10% Debentures A/c (Being the allotment of 20,000, 10% Debentures of ₹ 100 each as per Board's Resolution No... dated ...)	10,00,000	10,00,000
?	10% Debentures Allotment A/c Dr. To 10% Debentures A/c (Being the allotment money due on 20,000, 10% Debentures of ₹ 100 each — @ ₹ 50 per debenture as per Board's Resolution No... dated ...)	10,00,000	10,00,000
Feb. 7	Bank A/c Dr. To 10% Debentures Allotment A/c (Being the allotment money received)	10,00,000	10,00,000
Dec. 31	Debentures Interest A/c Dr. To Bank A/c (Being debenture interest paid @ 10% on ₹ 20,00,000 for one year)	2,00,000	2,00,000
Dec. 31	Statement of Profit and Loss Dr. To Debenture Interest A/c (Being the amount of debenture interest transferred to Statement of Profit and Loss)	2,00,000	2,10,000
2012 Dec. 31	Debentures Interest A/c Dr. To Bank A/c (Being debenture interest paid @ 10% on ₹ 20,00,000 for one year)	2,00,000	2,00,000

Dec. 31	Statement of Profit and Loss To Debenture Interest A/c (Being the amount of debenture interest transferred to Statement of Profit and Loss)	Dr.	2,00,000	 2,10,000
2013 Jan. 1	Debentures Redemption A/c To Bank A/c (Being 5,000, 10% Debentures of ₹ 100 each purchased @ ₹ 102 per debenture for icancellation)	Dr.	5,10,000	 5,10,000
?	10% Debentures A/c Profit and Loss on Cancellation of Debentures A/c To Debenture Redemption A/c (Being the cancellation of 5,000, 10% Debentures as per Board's Resolution No... dated ...)	Dr. Dr.	5,00,000 10,000	 5,10,000
Dec. 31	Statement of Profit and Loss To Profit and Loss on Cancellation of Debentures A/c (Being the loss on cancellation transferred to Statement of Profit and Loss)	Dr.	10,000	 10,000
Dec. 31	Debentures Interest A/c To Bank A/c (Being debenture interest paid @ 10% on ₹ 15,00,000 for one year)	Dr.	1,50,000	 1,50,000
Dec. 31	Statement of Profit and Loss To Debenture Interest A/c (Being the amount of debenture interest transferred to Statement of Profit and Loss)	Dr.	1,50,000	 1,50,000
2014 Jan. 1	10% Debentures A/c To Debentureholders A/c (Being the amount payable on redemption of debentures transferred to Debentureholders Account as per Board's Resolution No... dated...)	Dr.	2,00,000	 2,00,000
?	Debentureholders A/c To Bank A/c (Being the amount paid to debentureholders)	Dr.	2,00,000	 2,00,000
Dec. 31	Debentures Interest A/c (Note 2) To Bank A/c (Being debenture interest paid @ 10% on ₹ 13,00,000 for one year)	Dr.	1,30,000	 1,30,000
Dec. 31	Statement of Profit and Loss To Debenture Interest A/c (Being the amount of debenture interest transferred to Statement of Profit and Loss)	Dr.	1,30,000	 1,30,000
2015 Jan. 1	Investment in Own Debentures A/c To Bank A/c (Being the purchase of 8,000 own debentures @ ₹ 98 each which will be held as investment)	Dr.	7,84,000	 7,84,000
Dec. 31	Debentures Interest A/c (Note 3) To Bank A/c To Interest on Own Debentures A/c (Being debenture interest paid @ 10% on ₹ 5,00,000 for one year to outsiders and on ₹ 8,00,000 transferred to Interest on Own Debentures Account)	Dr.	1,30,000	 50,000 80,000
Dec. 31	Statement of Profit and Loss To Debenture Interest A/c (Being the amount of debenture interest transferred to Statement of Profit and Loss)	Dr.	50,000	 50,000
Dec. 31	Interest on Own Debentures A/c To Statement of Profit and Loss (Being interest on own debentures credited to Statement of Profit and Loss)	Dr.	80,000	 80,000
2016 Jan. 1	10% Debentures A/c To Investment in Own Debentures A/c To Profit and Loss on Cancellation of Debentures A/c (Being the cancellation of 8,000, 10% Debentures as per Board's Resolution No... dated...)	Dr.	8,00,000	 7,84,000 16,000
?	10% Debentures A/c Premium on Redemption of Debentures A/c To Debentureholders A/c (Being the amount payable on redemption of debentures transferred to Debentureholders Account as per Board's Resolution No... dated...)	Dr. Dr.	5,00,000 25,000	 5,25,000

?	Debentureholders A/c	Dr.	5,25,000	
	To Bank A/c			5,25,000
	(Being the amount paid to Debentureholders)			
?	Profit & Loss on Cancellation of Debentures A/c	Dr.	16,000	
	Statement of Profit and Loss	Dr.	9,000	
	To Premium on Redemption of Debentures A/c			25,000
	(Being the premium on redemption of debentures adjusted against profit on cancellation of debentures and the balance transferred to Statement of Profit and Loss)			

Working Notes :

(1) On 1.1.2013 debentures of ₹ 5,00,000 was redeemed. Therefore, interest is payable on ₹ 15,00,000 @ 10%. Interest = 10% of ₹ 15,00,000 = ₹ 1,50,000.

(2) On 1.1.2014 debentures of ₹ 2,00,000 was redeemed. Therefore, interest is payable on ₹ 13,00,000 @ 10%. Interest = 10% of ₹ 13,00,000 = ₹ 1,30,000.

(3) On 1.1.2015 company purchased debentures of ₹ 8,00,000 as investment. Therefore, out of interest of ₹ 1,30,000, 50,000 to be paid in cash and ₹ 80,000 to be credited to Statement of Profit and Loss.

Illustration 14

X Ltd. has ₹ 1,50,000, 6% Debentures on 1.1.2016. There is no sinking fund for redemption of debentures. Interest is payable on 31st December each year.

On 1.4.2016 ₹ 10,000 own debentures are purchased at ₹ 94 by X Ltd. and immediately cancelled.

On 1.6.2016 ₹ 25,000 own debentures are purchased at ₹ 95 and held as investment.

On 1.10.2016 ₹ 30,000 own debentures are purchased at ₹ 96 and held as investment.

On 31.12.2016 own debentures kept as investment are cancelled.

Show Journal Entries and the relevant Ledger Accounts in the books of the company. Date of closing is 31st December.

Solution

In the books of X Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016 April 1	Debentures Redemption A/c (Note 1)	Dr.	9,250	
	Debentures Interest A/c	Dr.	150	
	To Bank A/c			9,400
	(Being the purchase of 100 debentures @ ₹ 94 for immediate cancellation)			
April 1	6% Debentures A/c	Dr.	10,000	
	To Debentures Redemption A/c			9,250
	To Profit & Loss on Cancellation of Debentures A/c			750
	(Being the cancellation of 100 debentures)			
June 1	Investment in Own Debentures A/c (Note 2)	Dr.	23,125	
	Debentures Interest A/c	Dr.	625	
	To Bank A/c			23,750
	(Being the purchase of 250 debentures @ ₹ 95 which will be held as investment)			
Oct. 1	Investment in Own Debentures A/c (Note 3)	Dr.	27,450	
	Debenture Interest A/c	Dr.	1,350	
	To Bank A/c			28,800
	(Being the purchase of 300 debentures @ ₹ 96 which will be held as investment)			
Dec. 31	Debentures Interest A/c	Dr.	5,100	
	To Bank A/c			5,100
	(Being interest paid for outstanding 850 debentures)			
	Debenture Interest A/c (Note 4)	Dr.	1,325	
	To Interest on Own Debentures A/c			1,325
	(Being the adjustment for interest on own debentures)			
Dec. 31	6% Debentures A/c (₹ 25,000 + ₹ 30,000)	Dr.	55,000	
	To Investment in Own Debentures A/c			50,575
	To Profit & Loss on Cancellation of Debentures A/c			4,425
	(Being the cancellation of 550 debentures held as investment)			
Dec. 31	Profit & Loss on Cancellation of Debentures A/c (₹ 750 + ₹ 4,425)	Dr.	5,175	
	To Capital Reserve A/c			5,175
	(Being profit on cancellation of debentures transferred to Capital Reserve Account)			

Dec. 31	Statement of Profit and Loss	Dr.	8,550	
	To Debenture Interest A/c			8,550
	(Being interest on debentures transferred to Statement of Profit and Loss)			
Dec. 31	Interest on Own Debentures A/c	Dr.	1,325	
	To Statement of Profit and Loss			1,325
	(Being interest on own debentures credited to Statement of Profit and Loss)			

Dr. 6% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Debentures Redemption A/c	9,250	1.1.2016	By Balance b/d	1,50,000
1.4.2016	To P/L on Canc. of Debentures A/c	750			
31.12.2016	To Investment in Own Debentures A/c	50,575			
31.12.2016	To P/L on Canc. of Debentures A/c	4,425			
31.12.2016	To Balance c/d	85,000			
		1,50,000			1,50,000

Dr. Debentures Redemption Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Bank A/c	9,250	1.4.2016	By 6% Debentures A/c	9,250

Dr. Investment in Own Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.6.2016	To Bank A/c	23,125	31.12.2016	By 6% Debentures A/c	50,575
1.10.2016	To Bank A/c	27,450			
		50,575			50,575

Dr. Interest on Own Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Statement of Profit and Loss	1,325	31.12.2016	By Debentures Interest A/c	1,325

Dr. Debentures Interest Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Bank A/c	150	31.12.2016	By Statement of Profit and Loss	8,550
1.6.2016	To Bank A/c	625			
1.10.2016	To Bank A/c	1,350			
31.12.2016	To Bank A/c	5,100			
31.12.2016	To Interest on Own Debentures A/c	1,325			
		8,550			8,550

Dr. Profit & Loss on Cancellation of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Capital Reserve A/c	5,175	1.1.2016	By 6% Debentures A/c	750
			31.12.2016	By 6% Debentures A/c	4,425
		5,175			5,175

Dr. Capital Reserve Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Balance c/d	5,175	31.12.2016	By P/L on Canc. of Debentures A/c	5,175

Tutorial Note : If nothing is mentioned in quoted price as to ex- interest or cum-interest, it should be taken as ***cum-interest*** price. However, in case of Government security, it is taken as ex-interest.

Working Notes : (1) Interest accrued upto 1.4.2016 = (₹ 10,000 x 6/100 x 3/12) = ₹ 150. Therefore, Debentures Redemption Account will be debited by ₹ (9,400 – 150) = ₹ 9,250.

(2) Interest accrued upto 1.6.2016 = (₹ 25,000 x 6/100 x 5/12) = ₹ 625. Therefore, Own Debentures Account will be debited by ₹ (23,750 – 625) = ₹ 23,125.

(3) Interest accrued upto 1.10.2016 = (₹ 30,000 x 6/100 x 9/12) = ₹ 1,350. Therefore, Own Debentures Account will be debited by ₹ (28,800 – 1,350) = ₹ 27,450.

(4) Interest on Debentures : (On ₹ 25,000 for 7 months = ₹ 875) + (On ₹ 30,000 for 3 months = ₹ 450) = ₹ 1,325.

Illustration 15

On 1st July 2014, H.P. Ltd issued 2,000, 6% Debentures of ₹ 100 each. The interest is payable on 30th June and 31st December every year. The company is allowed to purchase its own debentures which may be cancelled or kept or re-issued at the company's option. The company made the following purchases by cheque in the open market.

On 31st May 2015, 200 Debentures @ ₹ 98 ex-interest. On 30th September 2016, 100 Debentures @ ₹ 97 cum-interest. The debentures, which were purchased on 31st May 2015, were cancelled on 31st December 2016. All payments were made on due dates.

Pass necessary Journal Entries to record the above transactions (including receipts and payments)

Solution

In the books of H.P. Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2014	Bank A/c	Dr.	2,00,000	
July 1	To Debentures Application A/c			2,00,000
	(Being money received in respect of 2,000, 6% Debentures of ₹ 100 each)			
July 1	Debentures Application A/c	Dr.	2,00,000	
	To 6% Debentures A/c			2,00,000
	(Being the issue of 2,000, 6% Debentures of ₹ 100 each at par)			
Dec. 31	Debenture Interest A/c	Dr.	6,000	
	To Bank A/c			6,000
	(Being payment of the half-yearly interest on 2,000 debentures)			
Dec. 31	Statement of Profit and Loss	Dr.	6,000	
	To Debenture Interest A/c			6,000
	(Being the interest on debentures transferred to Statement of Profit and Loss)			
2015	Investment in Own Debentures A/c (₹ 98 x 200)	Dr.	19,600	
May 31	Debenture Interest A/c	Dr.	500	
	To Bank A/c			20,100
	(Being purchase of 200 debentures @ ₹ 98 ex-interest)			
June 30	Debenture Interest A/c	Dr.	5,500	
	To Bank A/c			5,400
	To Interest on Own Debentures A/c			100
	(Being the interest on 1,800 debentures paid in cash and interest on own debentures for 1 month credited to Interest on Own Debenture Account)			
Dec. 31	Debenture Interest A/c	Dr.	6,000	
	To Bank A/c			5,400
	To Interest on Own Debentures A/c			600
	(Being interest on 1,800 debentures paid in cash and interest on 200 debentures credited to Interest on Own Debentures Account)			
Dec. 31	Statement of Profit and Loss	Dr.	12,000	
	To Debenture Interest A/c			12,000
	(Being interest on debentures transferred to Statement of Profit and Loss)			
	Interest on Own Debentures A/c	Dr.	700	
	To Statement of Profit and Loss			700
	(Being interest on own debentures credited to Statement of Profit and Loss)			
2016	Debenture Interest A/c	Dr.	6,000	
June 30	To Bank A/c			5,400
	To Interest on Own Debentures A/c			600
	(Being the interest on 1,800 debentures paid in cash and interest on 200 debentures credited to Interest on Own Debentures Account)			
Sept. 30	Investment in Own Debentures A/c (Note 1)	Dr.	9,550	
	Debenture Interest A/c	Dr.	150	
	To Bank A/c			9,700
	(Being the purchase of 100 debentures @ ₹ 97 cum-interest; interest on 3 months included in the purchase price)			
Dec. 31	Debenture Interest A/c	Dr.	5,850	
	To Bank A/c			5,100
	To Interest on Own Debentures A/c			750
	(Being the interest on 1,700 debentures paid in cash and the interest on 200 debentures for 6 months and the interest on 100 debentures for 3 months credited to Interest on Own Debentures Account)			

Dec. 31	6% Debentures A/c To Investment in Own Debentures A/c To Profit on Cancellation A/c (Being the cancellation of 200 debentures purchased on May 2015)	Dr.	20,000	 19,600 400
Dec. 31	Profit on Cancellation A/c To Capital Reserve A/c (Being the profit on cancellation of debentures transferred to Capital Reserve Account)	Dr.	400	 400
Dec. 31	Statement of Profit and Loss To Debenture Interest A/c (Being the interest on debentures transferred to Statement of Profit and Loss	Dr.	12,000	 12,000
Dec. 31	Interest on Own Debentures A/c To Statement of Profit and Loss (Being the interest on own debentures transferred to Statement of Profit and Loss	Dr.	1,350	 1,350
Dec. 31	Statement of Profit and Loss To General Reserve A/c (Being the amount transferred to General Reserve)	Dr.	20,000	 20,000

Working Notes :

(1) When debentures are purchased cum-interest, Investment in Own Debentures Account is debited with the amount of purchase price less interest accrued upto the date of purchase. Therefore, Investment in Own Debentures Account is to be debited by ₹ 9,700 less ₹ 150 = ₹ 9,550. It should be noted that even though ₹ 9,700 debentures have been purchased for ₹ 9,550, there is no profit. Question of profit or loss will arise at the time of cancellation of these debentures.

(2) An amount equal to the face value of debentures redeemed is to be transferred to general reserve.

Illustration 16

X Ltd. has an authorised capital of ₹ 15,00,000 divided into equity shares of ₹ 10 each and its Balance Sheet as on 31st December, 2016 was as follows :

X Ltd
Balance Sheet as at 31st December, 2016

Particulars	Note No.	Figures as at the end of current reporting period (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus	(2)	6,70,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6% Debentures		4,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		1,00,000
(c) Other Current Liabilities		1,10,000
(d) Short-term Provisions		—
TOTAL		17,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	12,00,000
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—

(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments — Investments in own Debentures (Nominal value ₹ 1,00,000)		85,000
(b) Inventories		2,00,000
(c) Trade Receivables		1,00,000
(d) Cash and Cash Equivalents		95,000
(e) Short-term Loans and Advances		50,000
(f) Other Current Assets		50,000
TOTAL		17,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
Issued and Subscribed Capital :	
50,000 Equity Shares of ₹ 10 each fully paid-up	5,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve	1,20,000
General Reserve	2,00,000
Statement of Profit and Loss	3,50,000
	6,70,000

(3) Fixed Assets

Particulars	₹
(a) *Tangible Assets :*	
Land and Building	4,00,000
Plant and Machinery	6,00,000
Furniture	2,00,000
	12,00,000

The 6% Debentures were due for payment on 30th June, 2017 at a premium of 5%. The company decided to —

(i) issue to the public 25,000 equity shares of ₹ 10 each at ₹ 15 per share. The money was duly received;

(ii) redeem out of profits the debentures on 30th June, 2017 together with interest for 6 months;

(iii) give the debentureholders an option to receive either cash in repayment of the amount due or new 6% Debentures (2022) at par. The holders of ₹ 1 lakh of the old debentures accepted new debentures. The debentures which the company held as investment were cancelled.

You are required to pass necessary Journal Entries giving effect to the above transactions.

Solution

In the books of X Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2017 June 30	Bank A/c	Dr.	3,75,000	
	To Equity Share Application A/c			3,75,000
	(Being the application money received on 25,000 equity shares @ ₹ 15 each)			
June 30	Equity Share Application A/c	Dr.	3,75,000	
	To Equity Share Capital A/c			2,50,000
	To Securities Premium A/c			1,25,000
	(Being the issue of 25,000 shares of ₹ 10 each at a premium of ₹ 5 per share as per Board's Resolution No. . . . dated . . .)			
June 30	6% Debentures A/c	Dr.	1,00,000	
	To Investments in Own Debentures A/c			85,000
	To Profit and Loss on Cancellation of Debentures A/c			15,000
	(Being the cancellation of debentures of ₹ 1,00,000 held as investments)			
June 30	6% Debentures A/c	Dr.	3,00,000	
	Premium on Redemption of Debentures A/c	Dr.	15,000	
	To Debentureholders A/c			3,15,000
	(Being the amount payable to debentureholder for redemption of debenture at a premium of 5%)			
June 30	Debenture Interest A/c (Note 2)	Dr.	12,000	
	To Debentureholders A/c			9,000
	To Interest on Own Debentures A/c			3,000
	(Being the interest on debentures for 6 months)			

June 30	Debentureholders A/c Dr. To 6% Debentures (2020) A/c (Being the issue of new debentures to the holders of ₹ 1,00,000 debentures including the interest and premium thereon)	1,08,000	1,08,000
June 30	Debentureholders A/c Dr. To Bank A/c (Being the amount paid to debentureholders holding ₹ 2,00,000 of debentures including premium and interest thereon)	2,16,000	2,16,000
June 30	Profit and Loss on Cancellation of Debentures A/c (Note 1) Dr. To Premium on Redemption of Debentures A/c (Being the adjustment of premium on redemption against profit on cancellation of debentures)	15,000	15,000
June 30	Statement of Profit and Loss (Note 3) Dr. To General Reserve A/c (Being the amount transferred to General Reserve Account)	2,00,000	2,00,000

Working Notes :

(1) Premium on redemption of debenture has not been provided at the time of issue of debentures. Now, it has been adjusted against the profit on cancellation of debentures.

(2) At the end of the accounting year, Debentures Interest is debited to Statement of Profit and Loss and Interest on Own Debenture is credited to Statement of Profit and Loss.

(3) Amount transferred to General Reserve is calculated as follows :

		₹
Nominal value of debentures redeemed		4,00,000
Less : Own debentures cancelled	1,00,000	
New debentures issued	1,00,000	2,00,000
Redemption out of profit		2,00,000

Illustration 17

Bharat Ltd. issued 2,000 6% Debentures of ₹ 100 each, interest being payable half-yearly on 31st March and 30th September in each year. There was a provision at the time of issue that the debentures can be redeemed by purchase from the market. The following purchases were made during the year end 31st December, 2015 and the cancellations were made on the following 31st March :

1st March, 2015 — Debentures of nominal value of ₹ 50,000 purchased for ₹ 49,450 (ex-interest).

1st September, 2015 — Debentures of nominal value of ₹ 40,000 purchased for ₹ 40,250 (cum-interest).

You are required to draw up the following accounts upto the date of cancellation : (i) 6% Debentures Account; (ii) Own Debentures Investment Account showing nominal value and interest in columnar form; and (iii) Debenture Interest Account.

[C.A. (Inter) — Adapted]

Solution

In the books of Bharat Limited

6% Debentures Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.12.2015	To Balance c/d	2,00,000	1.1.2015	By Balance b/d	2,00,000
31.3.2016	To Own Debentures Investment A/c	88,700	1.1.2016	By Balance b/d	2,00,000
31.3.2016	To P/L on Canc. of Debentures A/c	1,300			
31.3.2016	To Balance c/d	1,10,000			
		2,00,000			2,00,000

Debenture Interest Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.3.2015	To Bank A/c (Note 2)	4,500	1.1.2015	By Balance b/d (Note 1)	3,000
31.3.2015	To Interest on Own Debentures A/c (Note 3)	1,500	31.12.2015	By Statement of Profit and Loss	12,000
30.9.2015	To Bank A/c (Note 4)	3,300			
30.9.2015	To Int. on Own Debentures A/c (Note 5)	2,700			
31.12.2015	To Balance c/d (Accrued int. on ₹ 2,00,000 for 3 months)	3,000			
		15,000			15,000
31.3.2016	To Bank A/c (Note 6)	3,300	1.1.2016	By Balance b/d (Accrued interest)	3,000
31.3.2016	To Interest on Own Debentures A/c	2,700			

Dr. **Own Debentures Investment Account** **Cr.**

Date	Particulars	Nominal	Interest	Cost	Date	Particulars	Nominal	Interest	Cost
2015		₹	₹	₹	2015		₹	₹	₹
Mar. 1	To Bank A/c (Ex-int.)	50,000	1,250	49,450	Mar. 31	By Debenture Int. A/c	—	1,500	—
Sept. 1	To Bank A/c (Cum-int)	40,000	1,000	39,250	Sept. 30	By Debenture Int. A/c	—	2,700	—
Dec. 1	To P & L A/c (Note)	—	3,300	—	Dec. 31	By Accumulated Debenture Int. A/c	—	1,350	—
					Dec. 31	By Balance c/d	90,000	—	88,700
		90,000	5,550	88,700			90,000	5,550	88,700
2016					2016				
Jan.1	To Balance b/d	90,000	1,350	88,700	Mar.31	By Debenture Int. A/c	—	2,700	—
Dec. 31	To P & L A/c	—	1,350	—	Mar. 31	By 6% Debenture A/c	90,000	—	88,700
		90,000	2,700	88,700			90,000	2,700	88,700

Working Notes :

(1) Last interest was paid on 30.9.2014. The date of closing the books of accounts is 31st December. Therefore, accrued interest for Oct., Nov., and Dec, 2014 was provided in the final accounts of 2014. On 1.1.2015 it was brought forward, the amount will be ₹ 2,00,000 x 6/100 x 3/12 = ₹ 3,000.

(2) On 31.3.2015 outsiders were holding debentures of ₹ 1,50,000. So, interest to be paid in cash = ₹ 1,50,000 x 6/100 x 1/2 = ₹ 4,500.

(3) On 31.3.2015 own debentures investment were ₹ 50,000. So, interest will be ₹ 50,000 x 6/100 x 1/2 = ₹ 1,500.

(4) On 30.9.2015 outsiders were holding debentures of ₹ 1,10,000. So, interest to be paid in cash = ₹ 1,10,000 x 6/10 x 1/2 = ₹ 3,300.

(5) On 30.9.2015 own debentures investment were ₹ 90,000. So, interest will be ₹ 90,000 x 6/100 x 1/2 = ₹ 2,700.

(6) On 31.3.2016 outsiders were holding debentures of ₹ 1,10,000. So, interest to be paid in cash = ₹ 1,10,000 x 6/100 x 1/2 = ₹ 3,300.

(7) On 31.3.2016 own debentures investment were (just before cancellation) ₹ 90,000. So, interest will be ₹ 90,000 x 6/100 x 1/2 = ₹ 2,700.

2. Where there is Sinking Fund / Debenture Redemption Reserve Fund

As per Rule 8 of the Companies (Share Capital and Debentures) Rules, 2014, all companies (except All India Financial Institutions (AIFIs), Banking Companies and Financial Institutions) including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of debentures.

Every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than ***fifteen percent***, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-

(i) in deposits with any scheduled bank, free from any charge or lien;

(ii) in unencumbered securities of the Central Government or of any State Government;

(iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

(iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;

(v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above:
Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

When debentures are redeemed, the company requires a huge amount of money to pay the debentureholders. If proper planning is not done, there will be strain on working capital and the company may face liquidity crisis because of outflow of huge cash. To avoid such a situation many companies may prefer to create a Debenture Redemption Reserve Fund / Sinking Fund. Every year an adequate amount is transferred to DRRF / Sinking fund by deducting from profits after tax. The amount so deducted / appropriated is invested outside the business in risk-free high return instruments. At the time of need, these investments are realised and the money is used for the redemption of the debentures.

In the Balance Sheet Debenture Redemption Reserve Fund / Sinking Fund is shown under '***Reserve and Surplus***' in the Equity and Liabilities section.

ebenture Redemption Reserve Fund Investment / Sinking Fund Investment is shown under the main heading 'Non-current Asset' and sub-heading 'Non-current Investment'. Other things remaining the same, balance in these two accounts should be equal.

After redemption, the balance of Debenture Redemption Reserve Fund / Sinking Fund Account is transferred to Capital Reserve Account.

Definition of Sinking Fund

B.G. Wickery has defined sinking fund, as under:

"A sinking fund may be defined as a fund, created by a charge against or an appropriation of profits and represented by specific investments, which is brought into existence for a special purpose, such as replacement of an asset at the expiration of its life, or the redemption of debentures".

*Accounting Entries for Creation of Sinking Fund / Debenture Redemption Reserve Fund**

At the end of the 1st year

(a) For annual contribution (determined with the help of Sinking Fund Table)

Statement of Profit and Loss	Dr.
To Sinking Fund Account	

(b) For investing the amount set aside

Sinking Fund Investment Account	Dr.
To Bank Account	

At the end of the 2nd and subsequent years

(a) For receiving interest on sinking fund investment

Bank Account	Dr.
To Interest on Sinking Fund Investment Account	

(b) For transferring interest on sinking fund investment to sinking fund account

Interest on Sinking Fund Investment Account	Dr.
To Sinking Fund Account	
Alternatively,	
Bank Account	Dr.
To Sinking Fund Account	

(c) For annual contribution

Statement of Profit and Loss	Dr.
To Sinking Fund Account	

(d) For investing the amount set aside plus interest received during the year

Sinking Fund Investment Account	Dr. (Contribution plus interest)
To Bank Account	

At the end of the year of redemption

(a) For receiving interest on sinking fund investment

Bank Account	Dr.
To Interest on Sinking Fund Investment Account	

(b) For transferring interest on sinking fund investment to sinking fund account

Interest on Sinking Fund Investment Account	Dr.
To Sinking Fund Account	

*The terms 'Sinking Fund' and 'Debenture Redemption Reserve Fund' have been used to mean the same thing. In this chapter, we have used mainly the term 'Sinking Fund'.

(c) For annual contribution

Statement of Profit and Loss	Dr.
To Sinking Fund Account	

(d) For realisation of sinking fund investments

Bank Account	Dr.
To Sinking Fund Investment Account	

(e) For profit on sale of investment

Sinking Fund Investment Account	Dr.
To Sinking Fund Account	

(f) For loss on sale of investment

Sinking Fund Account	Dr.
To Sinking Fund Investment Account	

(g) For redemption of debentures at a premium

Debenture Account	Dr.
Premium on Redemption of Debentures Account	Dr.
To Debentureholders Account	

(h) For payment to debentureholders

Debentureholders Account	Dr.
To Bank Account	

(i) For transferring premium on redemption of debentures

Sinking Fund Account	Dr.
To Premium on Redemption of Debentures Account	

At the end of the year of redemption of debenture, annual contribution and interest of that year are not invested outside. On that date all the investments are sold.

(j) For transferring part of the sinking fund no longer required

Sinking Fund Account	Dr.
To General Reserve Account	

Students should note that frequently the expression "Debenture Redemption Fund Account" is used instead of "Sinking Fund Account". Likewise, "Debenture Redemption Fund Investment Account" is used in place of "Sinking Fund Investment Account". These expressions are used interchangeably.

Illustration 18

X Ltd issued on 1st January, 2012 debentures of the face value of ₹ 7,500 at par, repayable at par at the end of five years. In terms of the trust deed, a sinking fund was to be created for the purpose of accumulating sufficient funds. Investments were made yielding 5% interest received at the end of each year. All investments, including re-investments of interest received, were made at the end of the year.

You are required to show for 5 years, the — (a) Sinking Fund Account; and (b) Sinking Fund Investment Account.

Note: ₹ 2.71462 invested at the end of each year at 5 percent compound interest will amount to ₹ 15 at the end of 5 years.

Solution

Annual contribution = ₹ 2.71462/15 x ₹ 7,500 = ₹ 1,357.31.

In the books of X Ltd.

Dr. Sinking Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2012	To Balance c/d	1,357.31	31.12.2012	By Profit and Loss Appropriation A/c	1,357.31
31.12.2013	To Balance c/d	2,782.49	1.1.2013	By Balance b/d	1,357.31
			31.12.2013	By Int, on Sinking Fund Investment A/c	67.87
			31.12.2013	By Profit and Loss Appropriation A/c	1,357.31
		2,782.49			2,782.49

31.12.2014	To Balance c/d	4,278.92	1.1.2014	By Balance b/d	2,782.49
			31.12.2014	By Int. on Sinking Fund Investment A/c	139.12
			31.12.2014	By Profit and Loss Appropriation A/c	1,357.31
		4,278.92			4,278.92
31.12.2015	To Balance c/d	5,850.18	1.1.2015	By Balance b/d	4,278.92
			31.12.2015	By Int. on Sinking Fund Investment A/c	213.95
			31.12.2015	By Profit and Loss Appropriation A/c	1,357.31
		5,850.18			5,850.18
31.12.2016	To General Reserve A/c	7,500.00	1.1.2016	By Balance b/d	5,850.18
			31.12.2016	By Int. on Sinking Fund Investment A/c	292.51
			31.12.2016	By Profit and Loss Appropriation A/c	1,357.31
		7,500.00			7,500.00

Dr. **Sinking Fund Investment Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.12.2012	To Bank A/c	1,357.31	31.12.2012	By Balance c/d	1,357.31
1.1.2013	To Balance b/d	1,357.31	31.12.2013	By Balance c/d	2,782.49
31.12.2013	To Bank A/c (₹ 1,357.31 + 67.87)	1,425.18			
		2,782.49			2,782.49
1.1.2014	To Balance b/d	2,782.49	31.12.2014	By Balance c/d	4,278.92
31.12.2014	To Bank A/c (₹ 1,357.31 + 139.12)	1,496.43			
		4,278.92			4,278.92
1.1.2015	To Balance b/d	4,278.92	31.12.2015	By Balance c/d	5,850.18
31.12.2015	To Bank A/c (₹ 1,357.31 + 213.95)	1,571.26			
		5,850.18			5,850.18
1.1.2016	To Balance b/d	5,850.18	31.12.2016	By Bank A/c (sale of investments)	5,850.18

Tutorial Notes:

(1) Interest on Sinking Fund Investment is credited to Sinking Fund Account.

(2) In the year of redemption, annual contribution and sinking fund interest of that year are not reinvested.

(3) After the completion of redemption, balance of sinking fund is transferred to General Reserve Account.

Illustration 19

The following balances appeared in the books of Y Ltd. on 1.4.2017 :

(i) Sinking Fund Account — ₹ 50,000;

(ii) Sinking Fund Investment Account — ₹ 48,000; (10% Government Securities, nominal value ₹ 45,000);

(iii) 12% Debentures Account — ₹ 1,00,000. The company sold ₹ 30,000 Government Securities at 110% and redeemed part of the debentures at a premium of 10%.

Show Debentures Account, Sinking Fund Account and Sinking Fund Investment Account.

Solution **In the books of Y Ltd.**

Dr. **12% Debentures Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Debentureholders A/c	30,000	1.4.2017	By Balance b/d	1,00,000
1.4.2017	To Balance c/d	70,000			
		1,00,000			1,00,000
			1.4.2017	By Balance b/d	70,000

Dr. **Sinking Fund Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Premium on Redemption of Debenture A/c	3,000	1.4.2017	By Balance b/d	50,000
1.4.2017	To General Reserve A/c	30,000	1.4.2017	By Sinking Fund Investment A/c (Note 2)	1,000
1.4.2017	To Balance c/d	18,000			
		51,000			51,000
			1.4.2017	By Balance b/d	18,000

Dr. Sinking Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Balance b/d (nominal value — ₹ 45,000)	48,000	1.4.2017	By Bank A/c	33,000
1.4.2017	To Sinking Fund A/c (Note 2)	1,000	1.4.2017	By Balance c/d	16,000
		49,000			49,000
1.4.2017	To Balance b/d	16,000			

Working Notes :

Dr. (1) Debentureholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Bank A/c	33,000	1.4.2017	By 12% Debentures A/c	30,000
			1.4.2017	By Premium on Redemption of Debenture A/c	3,000
		33,000			33,000

(2) Profit on Sale of Investments

	₹
Sale proceeds from investments (₹ 30,000 x 110%)	33,000
Less: Cost of investments sold (₹ 48,000 / 45,000 x 30,000)	32,000
Profit on sale of investments	1,000

Illustration 20

The following balances appeared in the books of Royco Ltd. on 1.4.2017 :

(1) Debenture Redemption Fund ₹ 60,000 represented by investments of an equal amount (nominal value ₹ 75,000).

(2) The 12% Debentures stood at ₹ 90,000.

The company sold required amount of investments at 90% for redemption of ₹ 30,000 Debentures at a premium of 20% on the above date. Show the (i) 12% Debentures Account; (ii) Debenture Redemption Fund Account; (iii) Debenture Redemption Fund Investment Account; and, (iv) Debentureholders Account.

Solution

In the books of Royco Ltd.

Dr. 12% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Debentureholders A/c	30,000	1.4.2017	By Balance b/d	90,000
1.4.2017	To Balance c/d	60,000			
		90,000			90,000
			1.4.2017	By Balance b/d	60,000

Dr. Debenture Redemption Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Premium on Redem. of Debenture A/c	6,000	1.4.2017	By Balance b/d	60,000
1.4.2017	To General Reserve A/c (transferred)	30,000	1.4.2017	By Debenture Redem. Fund Investment A/c	4,000
1.4.2017	To Balance c/d	28,000			
		64,000			64,000
			1.4.2017	By Balance b/d	28,000

Dr. Debenture Redemption Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Balance b/d (nominal value ₹ 75,000)	60,000	1.4.2017	By Bank A/c	36,000
1.4.2017	To Debenture Redem. Fund A/c (Note 2)	4,000	1.4.2017	By Balance c/d	28,000
		64,000			64,000
1.4.2017	To Balance b/d	28,000			

Dr. Debentureholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2017	To Bank A/c	36,000	1.4.2017	By 12% Debentures A/c	30,000
			1.4.2017	By Premium on Redem. of Debenture A/c	6,000
		36,000			36,000

Working Notes :

(1) Debentures of ₹ 30,000 is to be redeemed at a premium of 20%. Therefore, the amount payable to the debentureholders is ₹ 30,000 x 120% = ₹ 36,000. To get ₹ 36,000, investments worth ₹ 40,000 is to be sold at 90% (₹ 36,000 / 90% = ₹ 40,000).

(2) **Profit on Sale of Investments :**

	₹
Sale proceeds from investments (as above)	36,000
Less: Cost of investments sold (₹ 60,000 / 75,000 x 40,000)	32,000
Profit on sale of investments	4,000

Illustration 21

The Balance Sheet of Zenith Ltd. as at 31.3.2016 supplied the following information :

	₹
13% Debenture Account	7,00,000
Debenture Redemption Fund Account	5,00,000
13% Debenture Redemption Fund Investment Account	5,00,000
The annual contribution to Debenture Redemption Fund	70,000

The debentures were redeemed on 31.3.2017, when investments were sold for ₹ 7,00,000 and the debentures were redeemed. Prepare : (i) Debenture Account; (ii) Debenture Redemption Fund Account; and (ii) 13% Debenture Redemption Fund Investment Account.

Solution

In the books of Zenith. Ltd.

Dr. 13% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.3.2017	To Debentureholders A/c	7,00,000	1.4.2016	By Balance b/d	7,00,000

Dr. Debenture Redemption Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.3.2017	To General Reserve A/c	8,35,000	1.4.2016	By Balance b/d	5,00,000
			31.3.2017	By 13% Debenture Redemption Fund Investment A/c (profit on sale)	2,00,000
			"	By Profit and Loss Appropriation A/c (Annual contribution)	70,000
			"	By Interest on Investment A/c	65,000
		8,35,000			8,35,000

Dr. 13% Debenture Redemption Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Balance b/d	5,00,000	31.3.2017	By Bank A/c	7,00,000
31.3.2017	To Debenture Redemption Fund A/c (Profit on sale of investment–transferred)	2,00,000			
		7,00,000			7,00,000

Illustration 22

The following balances appeared in the books of P. Ltd. on 1.1.2016 : 12% Debentures — ₹ 4,00,000; Sinking Fund ₹ 3,00,000; Sinking Fund Investment ₹ 3,00,000 (represented by 10% ₹ 3,60,000 secured bonds of Government of India).

Annual contribution to the Sinking Fund was ₹ 64,000 made on 31st December each year. On 31.12.2016, balance at bank was ₹ 2,00,000 after receipt of interest. The company sold the investments at 80% and debentures were paid off.

You are required to prepare the following accounts for the year 2016: (a) Debentures Account; (b) Sinking Fund Account; (c) Sinking Fund Investment Account; (d) Bank Account.

Solution

In the books of P. Ltd.

Dr. 12% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Debentureholders A/c	4,00,000	1.1.2016	By Balance b/d	4,00,000

Dr. Sinking Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Sinking Fund Invest. A/c (Note 1)	12,000	1.1.2016	By Balance b/d	3,00,000
31.12.2016	To General Reserve A/c (transferred)	3,88,000	31.12.2016	By Bank A/c (interest received)	36,000
			31.12.2016	By Profit and Loss Appropriation A/c	64,000
		4,00,000			4,00,000

Dr. Sinking Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.1.2016	To Balance b/d (face value ₹ 3,60,000)	3,00,000	31.12.2016	By Bank A/c — sold (at 80% of ₹ 3,60,000)	2,88,000
			31.12.2016	By Sinking Fund A/c (Note 1)	12,000
		3,00,000			3,00,000

Dr. Bank Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Balance b/d	2,00,000	31.12.2016	By Debentureholders A/c	4,00,000
31.12.2016	To Sinking Fund Investment A/c	2,88,000	31.12.2016	By Balance c/d	88,000
		4,88,000			4,88,000

Working Note :

(1) Loss on Sale of Investments :

	₹
Cost of investment sold	3,00,000
Less: Sale proceeds of investments	2,88,000
Loss on sale of investments	12,000

Purchase in the Open Market (where there is sinking fund) for Immediate Cancellation

Sometimes a company may purchase its own debentures from stock market for immediate cancellation even when there is a sinking fund. Generally, the company is interested to purchase its own debentures when the prevailing price is advantageous to it and loss on sale of sinking fund investment, if any, is minimum.

In this connection, the following points are important:

(a) Any profit or loss on sale of sinking fund investment should be transferred to Sinking Fund Account.

(b) The difference between the face value of debentures cancelled and their actual cost (in case of cum-interest purchase, quotation price *less* accrued interest; and in case of ex-interest, quotation price) should be treated as profit or loss on cancellation of debentures. This ***profit on cancellation should be transferred to Capital Reserve Account*** as it is a capital profit.

(c) An amount equal to the face value of debentures cancelled shall be transferred to General Reserve (debiting Sinking Fund Account and crediting General Reserve Account).

Accounting Entries

(a) When debentures are purchased (cum-interest)

Debentures Redemption Account Dr. [Quoted price – accrued interest x No. of debentures purchased]
Debenture Interest Account Dr. [Accrued interest]
 To Bank Account [Total payment]

(b) When debentures are purchased (ex-interest)

Debentures Redemption Account Dr. [Quotation price x No. of debentures purchased]
Debenture Interest Account Dr. [Accrued interest]
 To Bank Account [Total payment]

(c) For sale of sinking fund investment

Bank Account Dr. [Total proceeds]
 To Sinking Fund Investment Account

(d) Profit / Loss on sale of investment is transferred to Sinking Fund Account. For profit, Sinking Fund Account is credited and Sinking Fund Investment Account is debited. In case of loss, the entry is reversed.

(e) For cancellation

(i) Debentures Account Dr. [Face value]
 To Debentures Redemption Account [Cost]
 To Capital Reserve / Sinking Fund Account [Profit]

or,

(ii) Debentures Account Dr. [Face value]
 Sinking Fund Account Dr. [Loss]
 To Debentures Redemption Account [Cost]

(f) For transferring the face of debentures cancelled to General Reserve Account

Sinking Fund Account Dr. [Face value of debentures cancelled]
To General Reserve Account

Illustration 23

SB Ltd. had 12% Debentures of ₹ 3,00,000 outstanding in its books as on 1.4.2016. It also had a balance of ₹ 1,20,000 in Sinking Fund Account represented by 10% investments (face value ₹ 1,50,000). On 31.12.2016, it sold investments of the face value of ₹ 30,000 @ ₹ 90 cum-interest and with the proceeds purchased own debentures of the face value of ₹ 30,000 for immediate cancellation.

The interest dates for both debentures and investments were 30th September and 31st March. Annual appropriations to Sinking Fund came to ₹ 31,000.

Pass Journal Entries and show necessary Ledger Accounts for the year ended 31.3.2017.

Solution

In the books of SB Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
30.9.2016	Bank A/c	Dr.	7,500	
	To Interest on Sinking Fund Investment A/c			7,500
	(Being the receipt of half-yearly interest @ 10% on ₹ 1,50,000)			
"	Debenture Interest A/c	Dr.	18,000	
	To Bank A/c			18,000
	(Being the half-yearly interest paid on debentures @ 12% on ₹ 3,00,000)			
31.12.2016	Bank A/c (90% of ₹ 30,000)	Dr.	27,000	
	To Sinking Fund Investment A/c			26,250
	To Interest on Sinking Fund Investment A/c (Note 1)			750
	(Being the sale of investments of the face value of ₹ 30,000 @ ₹ 90 cum-interest)			
"	Sinking Fund Investment A/c (Note 2)	Dr.	2,250	
	To Sinking Fund A/c			2,250
	(Being the profit on sale of investments transferred from Sinking Fund Investment to Sinking Fund)			
"	Debentures Redemption A/c (Note 3)	Dr.	26,100	
	Debenture Interest A/c (₹ 30,000 x 12% x 3/12)	Dr.	900	
	To Bank A/c			27,000
	(Being the purchase of debentures of ₹ 30,000 cum-interest for immediate cancellation)			
"	12% Debentures A/c	Dr.	30,000	
	To Debenture Redemption A/c			26,100
	To Capital Reserve A/c			3,900
	(Being the cancellation of debentures of ₹ 30,000, profit on cancellation transferred to Capital Reserve)			
"	Sinking Fund A/c	Dr.	30,000	
	To General Reserve A/c			30,000
	(Being the amount equal to the face value of debentures redeemed transferred from Sinking Fund Account to General Reserve Account)			
31.3.2017	Bank A/c	Dr.	6,000	
	To Interest on Sinking Fund Investment A/c			6,000
	(Being the receipt of half-yearly interest @ 10% on ₹ 1,20,000)			
"	Debenture Interest A/c	Dr.	16,200	
	To Bank A/c			16,200
	(Being the half-yearly interest paid on debentures @ 12% on ₹ 2,70,000)			
"	Interest on Sinking Fund Investment A/c (₹ 7,500 + 750 + 6,000)	Dr.	14,250	
	To Sinking Fund A/c			14,250
	(Being the credit balance of interest on Sinking Fund Investment transferred to Sinking Fund Account)			
"	Profit and Loss Appropriation Account	Dr.	31,000	
	To Sinking Fund A/c			31,000
	(Being the annual contribution towards Sinking Fund)			
"	Sinking Fund Investment A/c (₹ 31,000 + 14,250)	Dr.	45,250	
	To Bank A/c			45,250
	(Being the annual contribution towards Sinking Fund and interest earned during the period invested in Sinking Fund Investment)			

"	Statement of Profit and Loss (₹ 18,000 + 900 + 16,200) To Debenture Interest A/c (Being the debenture interest for the year transferred to Statement of Profit and Loss)	Dr.	35,100	35,100

Working Notes : (1) ₹ 30,000 x 10/100 x 3/12 (October to December) = ₹ 750.

(2) Profit on Sale of Investments

	₹
Sale proceeds from investments (₹ 27,000 – 750)	26,250
Less: Cost of investments sold (₹ 1,20,000 / 1,50,000 x 30,000)	24,000
Profit on sale of investments	2,250

(3) Total amount received by selling investment is ₹ 27,000. It was utilised for purchase of own debentures for immediate cancellation. Interest accrued on debentures purchased = ₹ 900. Therefore, cost of debenture purchased = ₹ 27,000 – 900 = ₹ 26,100.

Ledger

Dr. 12% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Debenture Redemption A/c	26,100	1.4.2016	By Balance b/d	3,00,000
31.12.2016	To Capital Reserve A/c	3,900			
31.3.2017	To Balance c/d	2,70,000			
		3,00,000			3,00,000

Dr. Sinking Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To General Reserve A/c	30,000	1.4.2016	By Balance b/d	1,20,000
31.3.2017	To Balance c/d	1,37,500	31.12.2016	By Sinking Fund Investment A/c	2,250
			31.3.2017	By Interest on Sinking Fund Investment A/c	14,250
			31.3.2017	By Profit and Loss Appropriation A/c	31,000
		1,67,500			1,67,500

Dr. Sinking Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Balance b/d (Face value ₹ 1,50,000)	1,20,000	31.12.2016	By Bank A/c	26,250
31.12.2016	To Sinking Fund A/c (Note 2)	2,250	31.3.2017	By Balance c/d	1,41,250
31.3.2017	To Bank A/c (₹ 31,000 + ₹ 14,250)	45,250			
		1,67,500			1,67,500

Dr. Interest on Sinking Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.3.2017	To Sinking Fund A/c — transfer	14,250	30.9.2016	By Bank A/c	7,500
			31.12.2016	By Bank A/c	750
			31.3.2017	By Bank A/c	6,000
		14,250			14,250

Dr. Debenture Interest Account Cr.

Date	Particulars	₹	Date	Particulars	₹
30.9.2016	To Bank A/c	18,000	31.3.2017	By Statement of Profit and Loss — transfer	35,100
31.12.2016	To Bank A/c	900			
31.3.2017	To Bank A/c	16,200			
		35,100			35,100

Dr. Debenture Redemption Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Bank A/c	26,100	31.12.2016	By 12% Debentures A/c	26,100

Purchase in the Open Market (where there is sinking fund) as Investment

Sometimes, a company may purchase its own debentures as sinking fund investment. When own debentures are purchased as investment, an account called ‘‘Investment in Own Debentures Account’’ is debited with actual cost and Bank Account is credited with the total payment.

When own debentures are kept as investment, the interest on such debentures is to be calculated for the period. It should be credited to Sinking Fund Account and debited to Debenture Interest Account at the end of the accounting period. Any profit or loss on sale of investment should be transferred to Sinking Fund Account.

In the Balance Sheet, Debentures will be shown at its original figure and Investment in Own Debentures Account will be shown on the assets side.

Accounting Entries

(a) When debentures are purchased (cum-interest)

Investment in Own Debentures Account	Dr. [(Quotation price – accrued interest) x No. of debentures purchased]
Debenture Interest Account	Dr. [Total accrued interest]
To Bank Account	

(b) When debentures are purchased (ex-interest)

Investment in Own Debentures Account	Dr. [Quotation price x No. of debentures purchased]
Debenture Interest Account	Dr. [Total accrued interest]
To Bank Account	

(c) For sale of sinking fund investment

Bank Account	Dr. [Total proceeds]
To Sinking Fund Investment Account	

(d) Profit / Loss on sale of investment is transferred to Sinking Fund Account. For profit, Sinking Fund Account is credited and Sinking Fund Investment Account is debited. In case of loss, the entry is reversed.

(e) For cancellation (when required)

(i) Debentures Account	Dr. [Face value]
To Investment in Own Debentures Account	[Cost]
To Sinking Fund Account	[Profit]
or, (ii) Debentures Account	Dr. [Face value]
Sinking Fund Account	Dr. [Loss]
To Investment in Own Debentures Account	[Cost]

(f) For transferring the face value of debentures cancelled to General Reserve Account

Sinking Fund Account	Dr.
To General Reserve Account	

(g) For transferring profits on cancellation of debenture to Capital Reserve Account

Sinking Fund Account	Dr.
To Capital Reserve Account	

No profit or loss is calculated at the time of purchase of own debentures. Only when it is cancelled, the profit or loss is calculated and transferred to Sinking Fund Account.

Illustration 24

M.M. Ltd had the following among their ledger opening balances as on 1st January, 2016:

11% Debentures Account (2018 issue)	₹ 50,00,000.
Debentures Redemption Fund Account	₹ 45,00,000.
13.5% Debentures in XY Ltd. Account (face value ₹ 20,00,000)	₹ 19,50,000.
Own Debentures Account (face value ₹ 20,00,000)	₹ 18,50,000.

As 31st December, 2016 was the date of redemption of the 2016 Debentures, the company started buying own debentures and made the following purchases in the open market:

1.2.2016, 2,000 Debentures at ₹ 98 cum-interest;
1.6.2016, 2,000 Debentures at ₹ 99 ex-interest.

Half-year interest is due on the debentures on the 30th June and 31st December in the case of both the companies. On 31st December, 2016, the debentures in XY Ltd were sold for ₹ 95 each ex-interest. On that date, the outstanding debentures of M. M. Ltd were redeemed by payment and by cancellation. You are required to show the following accounts: (i) 11% Debentures Account; (ii) Debentures Redemption Fund Account; (iii) 13.5% Debentures in XY Ltd; and (iv) Own Debentures Account (Round off calculation to the nearest rupee)

Solution

In the books of M. M. Ltd.

11% Debentures Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Own Debentures A/c	22,42,167	1.1.2016	By Balance b/d	50,00,000
31.12.2016	To Debentures Redemption Fund A/c (Profit on cancellation)	1,57,833			
31.12.2016	To Bank A/c	26,00,000			
		50,00,000			50,00,000

Dr. **Debenture Redemption Fund Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Debentures in XY Ltd. A/c (Loss on sale of investments)	50,000	1.1.2016	By Balance b/d	45,00,000
			31.12.2016	By Int.on Debentures in XY Ltd. A/c	2,70,000
31.12.2016	To Capital Reserve A/c (Note 3)	1,57,833	31.12.2016	By Interest on Own Debentures A/c	2,53,000
31.12.2016	To General Reserve A/c	49,73,000	31.12.2016	By 11% Debentures A/c (profit on canc.)	1,57,833
		51,80,833			51,80,833

Dr. **13.5% Debentures in XY Ltd. Account** **Cr.**

Date	Particulars	Nominal	Interest	Cost	Date	Particulars	Nominal	Interest	Cost
1.1.2016	To Balance b/d	20,00,000	—	19,50,000	30.6.2016	By Bank A/c (interest)	—	1,35,000	—
31.12.2016	To Deb. Red. Fund A/c	—	2,70,000	—	31.12.2016	By Bank A/c (interest)	—	1,35,000	—
					31.12.2016	By Bank A/c (sale)	20,00,000	—	19,00,000
					31.12.2016	By Deb. Red. Fund A/c (Loss on sale)	—	—	50,000
		20,00,000	2,70,000	19,50,000			20,00,000	2,70,000	19,50,000

Dr. **Own Debentures Account** **Cr.**

Date	Particulars	Nominal	Interest	Cost	Date	Particulars	Nominal	Interest	Cost
1.1.2016	To Balance b/d	20,00,000	—	18,50,000	30.6.2016	By Debenture Int. A/c	—	1,32,000	—
1.2.2016	To Bank A/c (Note 1)	2,00,000	1,833	1,94,167	31.12.2016	By Debenture Int. A/c	—	1,32,000	—
1.6.2016	To Bank A/c (Note 2)	2,00,000	9,167	1,98,000		By 11% Debentures A/c (Cancelled)	24,00,000	—	22,42,167
31.12.2016	To Deb. Red. Fund A/c	—	2,53,000	—					
		24,00,000	2,64,000	22,42,167			24,00,000	2,64,000	22,42,167

Working Notes:

(1) Total amount paid for purchase of 2,000 own debentures @ ₹ 98 cum-interest = ₹ 98 x 2,000 = ₹ 1,96,000. As these debentures were purchased cum-interest, the interest for January 2016, ₹ 1,833 = ₹ (2,00,000 x 11% x 1/12), is to be deducted from ₹ 1,96,000 to find out the cost of own debentures purchased. Therefore, cost of own debentures purchased = ₹ 1,96,000 – ₹ 1,833 = ₹ 1,94,167.

(2) As the debenture were purchased ex-interest, the cost of debentures = ₹ 99 x 2,000 = ₹ 1,98,000 and interest for 5 months will be ₹ (2,00,000 x 11% x 5/12) = ₹ 9,167.

(3) Profit on cancellation of debentures is a capital profit. When debentures are cancelled, Debentures Account is debited with the face value (₹ 24,00,000); Own Debentures Account is credited with cost price (₹ 22,42,167); Debentures Redemption Fund is also credited with the profit on cancellation. At the year end such profit is transferred to capital reserve by debiting Debentures Redemption Fund Account and crediting Capital Reserve Account.

Illustration 25

The following ledger balances are extracted from the books of PQ Ltd as on 30.9.2016:

	₹
9% Debentures issued @ ₹ 95	9,50,000
Debentures Redemption Reserve Fund	9,37,000
Investment against Debentures Redemption Reserve Fund	9,37,000

Following further information is given—

(i) Investments include debentures of the face value of ₹ 2,00,000 purchased on 1.8.2016 @ ₹ 99 ex-interest; (ii) Interest on Debentures is payable on 30th June and 31st December; (iii) All debentures are redeemable at par on 31st December; and (iv) Income from outside investments of Redemption Fund from 30.9.2016 to 31.12.2016 is ₹ 45,000.

Show necessary ledger accounts assuming that the above transactions have been carried out and all outside investments were sold at a profit of 10% over cost.

Solution

In the books of PQ Ltd.

Dr. 9% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Own Debentures Investment A/c	1,98,000	1.10.2016	By Balance b/d	9,50,000
31.12.2016	To Debentures Redemption Reserve Fund A/c (Profit on cancellation)	2,000			
31.12.2016	To Bank A/c	7,50,000			
		9,50,000			9,50,000

Dr. Debentures Redemption Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.10.2016	To Balance b/d	9,37,000	1.10.2016	By Own Debentures Investment A/c (Transferred to separate account)	1,98,000
	To Debentures Redem. Reserve Fund A/c	73,900	31.12.2016	By Bank A/c (₹ 7,39,000 x 110/100)	8,12,900
		10,10,900			10,10,900

Dr. Own Debentures Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.10.2016	To Debentures Redemp. Fund Invest. A/c	1,98,000	31.12.2016	By 9% Debentures A/c	1,98,000

Dr. Debentures Redemption Reserve Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2016	To Capital Reserve A/c (Note 1)	2,000	1.10.2016	By Balance b/d	9,37,000
31.12.2016	To General Reserve A/c	10,63,400	31.12.2016	By Debenture Interest A/c (Interest on own debentures of ₹ 2,00,000 for 5 months)	7,500
			31.12.2016	By Interest on Debentures Redemption Fund Investment A/c	45,000
			31.12.2016	By 9% Debentures A/c (Profit on cancellation)	2,000
				By Debentures Redemp. Fund Investment A/c (Profit on sale)	73,900
		10,65,400			10,65,400

Tutorial Notes:

(1) Profit on cancellation of own debentures should be treated as a capital profit.

(2) Though the data has been given for 30.9.2016, it is assumed that no interest on own debentures for the month of August and September have been adjusted in the two accounts. Therefore, interest on own debentures for 5 months has been credited to Debentures Redemption Reserve Fund.

Illustration 26

Light Limited had ₹ 12,00,000, 12% Debentures of ₹ 100 each outstanding on 31.3.2015. The following balances also appeared in the books of the company on the same date :

	₹
Sinking Fund (after crediting annual interest on investment and annual instalment of ₹ 30,000)	3,60,000
Sinking Fund Investment — 10% Government Securities (nominal value ₹ 2,40,000)	1,98,000
Own Debentures (nominal value ₹ 1,20,000)	1,14,000

Interest in all cases is payable or receivable on 30th September and 31st March every year. On 1.4.2015, required amount was invested in own debentures bought at ₹ 96 each. On 1.7.2015, own debentures held were cancelled and, in addition, ₹ 1,20,000 of the debentures were purchased in the open market at ₹ 95 each (cum-interest) and cancelled. The amount required was made available by selling 10% Government Securities at ₹ 81(cum-interest) to the nearest ₹ 100 of nominal value. Prepare the necessary Ledger Accounts.

Solution

In the books of Light Ltd.

Dr. Sinking Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.7.2015	To Sinking Fund Investment A/c (Note 5)	5,632	1.4.2015	By Balance b/d	3,60,000
31.3.2016	To Capital Reserve A/c (Note 8)	18,448	1.7.2015	By 12% Debentures A/c	18,448
31.3.2016	To General Reserve A/c (Nominal value of the debentures redeemed transferred — ₹ 1,20,000 + 71,200 + 1,20,000)	3,11,200	31.3.2016	By Interest on S.F. Investment A/c (Note 6)	13,440
			31.3.2016	By Interest on Own Debentures A/c (Note 7)	5,736
			31.3.2016	By Profit and Loss Appropriation A/c (annual appropriation)	30,000
31.3.2016	To Balance c/d	92,344			
		4,27,624			4,27,624

Dr. Sinking Fund Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d (Nominal value ₹ 2,40,000)	1,98,000	1.7.2015	By Bank A/c (Note 4)	1,10,528
			1.7.2015	By Sinking Fund A/c (Loss on sale) (Note 5)	5,632
			31.3.2016	By Balance c/d	81,840
		1,98,000			1,98,000

Dr. Investment in Own Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d (Nominal value ₹ 1,20,000)	1,14,000	1.7.2016	By 12% Debentures A/c (cancelled)	1,82,352
1.4.2015	To Bank A/c (Note 1)	68,352			
		1,82,352			1,82,352

Dr. Debentures Redemption Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.7.2016	To Bank A/c (Note 3)	1,10,400	1.7.2016	By 12% Debentures A/c	1,10,400

Dr. 12% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.7.2015	To Investment in Own Debentures A/c	1,82,352	1.4.2015	By Balance b/d	12,00,000
1.7.2015	To Sinking Fund A/c (Note 2 & 3)	18,448			
1.7.2015	To Debenture Redemption A/c	1,10,400			
31.3.2016	To Balance c/d	8,88,800			
		12,00,000			12,00,000

Working Notes :

(1) Ascertainment of the required amount invested in own debentures on 1.4.2015

Annual instalment + Interest for 1 year in Sinking Fund Investment Account + Interest for 1 year in Investment in Own Debentures Account = ₹ [30,000 + (10% on ₹ 2,40,000) + (12% on ₹ 1,20,000)] = ₹ (30,000 + 24,000 + 14,400) = ₹ 68,400].

Nominal value of debentures to be purchased at ₹ 96 by investing ₹ 68,400 = ₹ 68,400 / 96 x 100 = ₹ 71,250 or say ₹ 71,200 (nearest to ₹ 100). Therefore, actual amount to be invested is : ₹ 71,200 / 100 x 96 = ₹ 68,352.

Nominal value of investment in own debentures is, therefore, ₹ (1,20,000 + 71,200) = ₹ **1,91,200**

(2) Profit on cancellation of own debentures is the difference between nominal value of debentures and cost of acquiring these debentures. Therefore, profit on cancellation is ₹ [1,91,200 – (1,14,000 + 68,352)] = ₹ 8,848.

(3) To acquire nominal value of ₹ 1,20,000 debentures, the required amount is calculated as follows : Cost of ₹ 1,20,000 debentures at ₹ 95 each = ₹ 1,14,000; which includes accrued interest for 3 months (from 1.4.2015 to 30.6.2015), i.e., ₹ 3,600. Therefore, the net cost is ₹ (1,14,000 – 3,600) = ₹ 1,10,400. Profit on cancellation of debentures is ₹ (1,20,000 – 1,10,400) = ₹ 9,600.

(4) To realise ₹ 1,14,000 by selling government securities, the nominal value of securities to be sold ₹ 1,14,000 / 81 x 100 = ₹ 1,40,741 or say ₹ 1,40,800 (nearest to ₹ 100). Therefore, actual amount realised = ₹ 1,40,800 / 100 x 81 = ₹ 1,14,048 which will include interest for 3 months, i.e., ₹ 3,520 (@ 10% on ₹ 1,40,800 for 3 months). Therefore, the net amount realised from selling the investments = ₹ (1,14,048 – 3,520) = ₹ 1,10,528.

(5) Calculation of Loss on Sale of Investments

	₹
Cost of the investments sold — ₹ 1,98,000 / 2,40,000 x 1,40,800	1,16,160
Less: Sale proceeds of investments sold	1,10,528
Loss on sale of investments	5,632

(6) Calculation of Interest on Sinking Fund Investment Account	₹
@ 10% p.a. on ₹ 2,40,000 for 3 months (1.4.2015 – 30.6.2015)	6,000
@ 10% p.a. on ₹ (2,40,000 – 1,40,800) for 9 months (1.7.2015 – 31.3.2016)	7,440
	13,440

(7) Calculation of Interest on Own Debentures Account	₹
@ 12% p.a. on ₹ (1,20,000 + 71,200) for 3 months (1.4.2015 – 30.6.2015)	5,736

(8) Profit on cancellation [₹ (8,848 + 9,600) = ₹ 18,448] is a capital profit and transferred to Capital Reserve Account.

Illustration 27

Ajay Ltd. had 6% ₹ 1,00,000 debentures on 1.4.2016. Interest is paid annually on 31st March. The terms of issue provide that the company should pay to the trustees ₹ 12,000 each year to be applied by the trustees in redemption of debentures by purchase below par in the open market. It is also provided that 1/5th of the outstanding balance is to be redeemed from this year. If redemptions by purchase are below the required amount, the balance is redeemable at par by drawing lot on 31st March.

On 1.4.2016, the trustees had ₹ 16,900 represented by 5% investments (cost ₹ 16,000; face value ₹ 17,000) and ₹ 900 cash. The trustees purchased ₹ 13,000 debentures at ₹ 96 cum-interest on 30.9.2016 and the balance required was redeemed by lot. For this purpose, ₹ 12,750, 5% investments were sold (ex-interest) for ₹ 11,750, balance being met from cash in hand. Surplus cash in hand was invested to acquire investment of the face value of ₹ 6,000.

You are required to show the following in the books of the company :

(i) 6% Debentures Account; (ii) Debenture Trustees Fund Account; (iii) Debenture Trustees Investment Account; (iv) Debenture Trustees Cash Account; and (v) Debenture Interest Account. ***[C.S. (Inter) — Adapted]***

Solution

In the books of Ajay Ltd.

Dr. 6% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
30.9.2016	To Debenture Trustees' Cash A/c (Note 1)	12,090	1.4.2016	By Balance b/d	1,00,000
30.9.2016	To Debenture Trustees' Fund A/c (Note 2)	910			
31.3.2017	To Debenture Trustees' Cash A/c	7,000			
31.3.2017	To Balance c/d	80,000			
		1,00,000			1,00,000

Dr. Debenture Trustees' Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
30.6.2016	To General Reserve A/c	13,000	1.4.2016	By Balance b/d	16,900
30.6.2016	To Capital Reserve A/c	910	30.9.2016	By 6% Debentures A/c	910
30.6.2016	To Debenture Trustees' Invest. A/c (Note 3)	250	30.9.2016	By Interest on Investments A/c (Note 4)	319
31.3.2017	To General Reserve A/c	7,000	31.3.2017	By Interest on Investments A/c (Note 4)	213
31.3.2017	To Balance c/d	9,182	31.3.2017	By Profit & Loss Appropriation A/c	12,000
		30,342			30,342

Dr. Debenture Trustees' Investment Account Cr.

Date	Particulars	Face Value	Cost	Date	Particulars	Face Value	Cost
1.4.2016	To Balance b/d	17,000	16,000	30.9.2016	By Debenture Trustees' Cash A/c	12,750	11,750
31.3.2017	To Debenture Trustees' Cash A/c	6,000	6,092	30.9.2016	By Debenture Trustees' Fund A/c (Note 3)	—	250
				31.3.2017	By Balance c/d	10,250	10,092
		23,000	22,092			23,000	22,092

Dr. Debenture Trustees' Cash Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Balance b/d	900	30.9.2016	By 6% Debentures A/c	12,090
30.9.2016	To Debenture Trustees' Investment A/c	11,750	31.3.2016	By 6% Debentures A/c	7,000
30.9.2016	To Interest on Investments A/c (Note 4)	319	31.3.2016	By Debenture Trustees' Investment A/c	6,092
31.3.2017	To Interest on Investments A/c (Note 4)	213			
31.3.2017	To Bank A/c (Annual contribution)	12,000			
		25,182			25,182

Dr. **Debentures Interest Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
30.9.2016	To Bank A/c	390	31.3.2017	By Profit & Loss A/c	5,610
31.3.2017	To Bank A/c (6% on ₹ 87,000)	5,220			
		5,610			5,610

Working Notes :

(1) Price paid for ₹ 13,000 debentures purchased on 30.9.2014 is cum-interest. Total amount paid ₹ 12,480 which includes interest for 6 months (April to September) = ₹ (13,000 x 6% x 6/12) = ₹ 390 . The actual cost of debentures purchased = ₹ 12,480 – ₹ 390 = ₹ 12,090.

(2) **Profit on cancellation of debentures** = ₹ 13,000 – ₹ 12,090 = ₹ 910.

(3) **Loss on Sale of investments** = *₹ 12,000 – ₹ 11,750 = ₹ 250.

$* \frac{16,000}{17,000} \times 12,750 = 12,000(\text{Cost of investments sold})$

(4) **Interest on 5% Investments has been calculated as follows :**

On 30.9.2014 : ₹ 12,750 x 5% x 6 /12 = <u>₹ 319</u>

On 31.3.2015 : ₹ 4,250 x 5% for full year = <u>₹ 213</u>.

Insurance Policy Method

This is similar to the sinking fund method but, instead of investing the money in securities, the amount is used in paying premium on a policy taken out with an insurance company. The policy should mature immediately before the date of redemption of debentures. The money that is received from the insurance company is used for paying the debentureholders. Though the interest received is lower than could be obtained by investing in securities, the risk of loss on realisation of securities is avoided. The main disadvantage of this method is that the fund is available only after the maturity date of the policy. If the management wants to redeem debentures in open market operation, before the maturity date, this method cannot help much. However, funds can be arranged by surrendering the policy at a much lower value.

Accounting Entries

(a) For payment of yearly premium (at the commencement of the year)

Debentures Redemption Fund Policy Account Dr.
    To Bank Account

(b) For appropriation (at the year end)

Statement of Profit and Loss Dr.
    To Debentures Redemption Fund Account
[No entry will be passed for interest]

(c) For realisation of insurance policy

Bank Account Dr.
    To Debentures Redemption Fund Policy Account

(d) For transfer of excess policy money received over premium paid

Debentures Redemption Fund Policy Account Dr.
    To Debentures Redemption Fund Account

(e) After redemption of debentures, the balance of Debentures Redemption Fund Account is transferred to General Reserve Account.

At the end of each year, Debentures Redemption Fund Policy (cumulative premium) will appear on the assets section of the Balance Sheet, whereas, the Debentures Redemption Fund will appear on the 'Equity and Liabilities' section.

To be more conservative, some accountants are of the opinion that the Policy Account should be adjusted, at the year end, at its surrender value so as to maintain the policy in the Balance Sheet at its net realisable value. Others argue that there is no need to write-down the policy to its surrender value, because the policy is for a fixed sum and there is no intention of surrendering the policy.

Illustration 28

H.M. Co. Ltd. issues on 1st January, 2014, ₹ 2,00,000, 12% Debentures which are to be redeemed after 3 years. The company purchases an insurance policy for the redemption of debentures. Annual premium payable at the beginning of each year is ₹ 62,000.

You are required to show:

(i) Debentures Redemption Fund Policy Account; and

(ii) Debentures Redemption Fund Account in the books of the company.

Solution

In the books of H.M. Co. Ltd.

Dr. Debentures Redemption Fund Policy Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.1.2014	To Bank A/c (Premium)	62,000	31.12.2014	By Balance c/d	62,000
1.1.2015	To Balance b/d	62,000	31.12.2015	By Balance c/d	1,24,000
	To Bank A/c (Premium)	62,000			
		1,24,000			1,24,000
1.1.2016	To Balance b/d	1,24,000	31.12.2016	By Bank A/c (Realisation of policy)	2,00,000
1.1.2016	To Bank A/c (Premium)	62,000			
31.12.2016	To Debentures Redem. Fund A/c (Excess)	14,000			
		2,00,000			2,00,000

Dr. Debentures Redemption Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.2014	To Balance c/d	62,000	31.12.2014	By Profit & Loss Appropriation A/c	62,000
31.12.2015	To Balance c/d	1,24,000	1.1.2015	By Balance b/d	62,000
			31.12.2015	By Profit & Loss Appropriation A/c	62,000
		1,24,000			1,24,000
31.12.2016	To General Reseve A/c	2,00,000	1.1.2016	By Balance b/d	1,24,000
			31.12.2016	By Profit & Loss Appropriation A/c	62,000
			31.12.2016	By Debentures Redem. Fund Policy A/c	14,000
		2,00,000			2,00,000

Convertible Debentures

Convertible debentures are those which carry a provision of conversion in a number of shares at par or at a premium on or before a certain date. The dates and terms of the conversion are established at the time of the issue of debentures. A convertible debenture gives the holder the option to convert it into shares at a later date and also at a fixed price. In fact, it is a delayed form of equity financing.

Convertible debentures can be partly or fully convertible. When the entire amount of the debenture is convertible, it is called a ***fully convertible debenture*** (FCD). On the other hand, when only a part of the debenture is convertible, it is called a ***partly convertible debenture*** (PCD).

The main purpose of buying convertible debentures for an investor is that entry into the equity share capital may be postponed until the future prospects of the company become more clearly established. Convertible debentureholders are the secured lenders of the company at the early stage of development. By the process of conversion, they are given option to enjoy the right of becoming ***shareholders***, when the solvency, liquidity and managerial efficiency of the company are assured. If the market price of the shares into which the debentures can be converted should rise above the value of the debentures at the conversion price, a debentureholder will find it profitable to exercise the option of converting. This is why, convertible debentures have a speculative feature and tend to fluctuate in price in accordance with the movement of the shares prices into which they are convertible. To the potential investor, convertible debentures combine both safety of principal amount which is invested in debentures and possibility of enhancement in value through the conversion privilege.

The reason for issuing convertible debentures for the company is the increased chance of creating a large market for the sale of debentures. A company may not find it advantageous to raise additional capital by the issue of shares; it might also feel that debentures can only be sold at a higher rate of interest. The issue of convertible debentures is the answer to these problems. The rate of interest for convertible debentures is generally lower than that of ordinary debentures because it takes into account higher conversion value on redemption and, in effect, higher periodical returns in the future.

When the debentures are converted into shares, the fixed interest charges of the company are to that extent reduced. If a part of the total convertible debentures are not converted (some debentureholders do not exercise their option of converting), these debentures are ***redeemed in the usual way as per the terms of the agreement and debentureholders are paid-off accordingly***.

In fact, there may be several good reasons for not converting an investment in convertible debentures into shares. ***First***, the periodic interest payments received from the investment in convertible debentures may exceed the expected dividends that would be received from the shares into which the debentures will be converted. ***Secondly***, there is risk of a fall in the market price of a share, which an investor may weigh more heavily than the possibility of an increase in the market price. Convertible debentures ultimately mature and are redeemed at their maturity value. Shares, on the other hand, have no maturity value.

Following are the advantages of convertible debentures :

1. The debt is self-liquidating — there will be no cash outflow in the future.
2. There will be no capital gains tax for convertible debentureholders.
3. Capital gearing is reduced, paving the way for new loans.

The disadvantages are :

1. There may be future dilution in earnings per share.
2. There may not be any possibility of a bonus or rights issue in the near future.
3. Valuation techniques for conversion requires additional study.

When the debentures are convertible into shares, the conversion process is based on either conversion ratio or conversion price. A ***conversion ratio*** indicates how many shares will be received for each convertible debenture already held. For example, a company has 10,000, 12% convertible debentures of ₹ 10 each. Every 10 debentures are convertible into 12 equity shares of ₹ 10 each. Therefore, the number of equity shares to be issued for conversion is 12,000 (10,000 / 10 x 12). The conversion price is sometimes given instead of the conversion ratio. A ***conversion price*** is the price at which the principal amount of a convertible debenture may be issued to acquire shares in the issuing company. For example, a company has 10,000, 10% convertible debentures of ₹ 10 each redeemable at ₹ 12 each. They are convertible into equity shares of ₹ 60 each (face value ₹ 10). This indicates that for each 5 convertible debentures (5 x ₹ 12 = ₹ 60), one equity share of ₹ 10 each will be issued at a premium of ₹ 50 per share. Therefore, the conversion value of a convertible debenture is the total market value of shares for which it can be exchanged.

Students should note that there is no prohibition to issue debentures at a discount. Unlike the restrictions contained in Section 53 of the Companies Act, 2013 for the issue of shares at a discount. But, when the debentures are convertible into equity shares, the conversion should be at par or above the nominal value of equity shares.

Journal Entries

1. On receipt of application money

Cash/Bank Account	Dr.
To Debentures Application Account	

2. For allotment of debentures

Debentures Application Account	Dr.
To Convertible Debentures Account	

3. For conversion of the convertible debentures into equity / preference shares at par

Convertible Debentures Account	Dr.
To Equity / Preference Share Capital Account	

4. For conversion of the convertible debentures into equity / preference shares at a premium

Convertible Debentures Account	Dr.
To Equity / Preference Share Capital Account	
To Securities Premium Account	

Illustration 29

On 1st June 2016 Hindustan Computers Limited made a public issue of 10,000, 14% fully convertible debentures of ₹ 100 each for cash at par. The entire amount is payable on application. Allotment was made on 1st July, 2016. The entire face value of ₹ 100 of each debenture would be compulsorily and automatically converted into five equity shares of ₹ 10 each in the company credited as fully paid-up at a premium of ₹ 10 per share on the expiry of six months from the date of allotment.

On 31.12.2016 half-yearly interest had accrued on debentures and paid on that date.

Pass necessary Journal Entries assuming that accounting year closing on 31st December every year.

Solution

In the books of Hindustan Computers Limited

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016	Bank A/c	Dr.	10,00,000	
June 1	To Debentures Application A/c			10,00,000
	(Being application money received on 10,000 debentures @ ₹ 100 each)			
July 1	Debentures Application A/c	Dr.	10,00,000	
	To 14% Fully Convertible Debentures A/c			10,00,000
	(Being the allotment of 10,000, 14% fully convertible debentures of ₹ 100 each at par as per Board's Resolution No. . . . dated . . .)			
Dec. 31	Debenture Interest A/c	Dr.	70,000	
	To Bank A/c			70,000
	(Being half-yearly interest on debentures paid)			
Dec. 31	Statement of Profit and Loss	Dr.	70,000	
	To Debenture Interest A/c			70,000
	(Being the debenture interest transferred to Statement of Profit and Loss)			
Dec. 31	14% Fully Convertible Debentures A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			5,00,000
	To Securities Premium A/c			5,00,000
	(Being the conversion of 10,000, 14% FCD into 50,000 equity shares of ₹ 10 each at a premium of ₹ 10 per share as per Board's Resolution No. . . . dated . . .)			

Illustration 30

On 1.1.2016 Jamurki Ltd. issued 2,000, 15% Debentures of ₹ 100 each at 6% discount. Holders of these debentures have an option to convert their holdings into 18% Preference Shares of ₹ 100 each at ₹ 125 at any time within 3 years.

On 31.12.2016, yearly interest had accrued on the debentures and remained outstanding and a holder of 50 debentures notified his decision to exercise his option.

Pass the necessary Journal Entries.

Solution

In the books of Jamurki Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
2016	Bank A/c	Dr.	1,88,000	
Jan.1	To Debentures Application A/c			1,88,000
	(Being application money received on 2,000 debentures @ ₹ 94 each)			
?	Debentures Application A/c	Dr.	1,88,000	
	Discount on Issue of Debentures A/c	Dr.	12,000	
	To 15% Debentures A/c			2,00,000
	(Being the issue of 2,000, 15% Debentures of ₹ 100 each at 6% discount as per Board's Resolution No. . . . dated . . .)			
Dec. 31	Debenture Interest A/c	Dr.	30,000	
	To Accrued Debenture Interest A/c			30,000
	(Being the interest due on debentures)			
"	15% Debentures A/c (50 x ₹ 100)	Dr.	5,000	
	To 18% Preference Share Capital A/c (₹ 5,000 / 125 x 100)			4,000
	To Securities Premium A/c (₹ 5,000 / 125 x 25)			1,000
	(Being the conversion of 50, 15% Debentures of ₹ 100 each into 18% Preference Shares of ₹ 100 each at a premium of ₹ 25 per share as per Board's Resolution No. . . . dated . . .)			

"	Statement of Profit and Loss Dr. To Debenture Interest A/c (Being the debenture interest transferred to Statement of Profit and Loss)	30,000	30,000
"	Securities Premium A/c Dr. Statement of Profit and Loss Dr. To Discount on Issue of Debentures A/c (Being the discount on issue of debentures written-off)	1,000 11,000	12,000

Illustration 31

Tata Press Limited made a public issue of 15% Partly Convertible Debentures (PCD) of ₹ 150 each for cash at par aggregating ₹ 300 lakhs.

Issue opened on 1st June, 2016; issue closed on 15th June. Allotment made on 1st July, 2016.

Principal terms of PCD :

1. Entire amount is payable on application.
2. Each PCD will have a face value of ₹ 150 and shall consist of two parts—
   Part A : Convertible portion of ₹ 50; Part B : Non-convertible portion of ₹ 100.
3. Part A of each PCD will be automatically converted into 5 equity shares of ₹ 10 each at par on 31st December, 2016.
4. Part B of each PCD will be non-convertible.

Interest on all debentures were paid upto 31st December, 2016. You are required to pass necessary Journal Entries assuming that the accounting year closes on 31st December, every year.

Solution

In the books of Tata Press Limited
Journal

Date	Particulars	Dr. ₹ (Lakh)	Cr. ₹ (Lakh)
2016 June 15	Bank A/c Dr. To Debentures Application A/c (Being the amount received in respect of 2,00,000, 15% PCD of ₹ 150 each)	300	300
July 1	Debentures Application A/c Dr. To 15% Partly Convertible Debentures A/c (Being the allotment of 2,00,000, 15% partly convertible debentures of ₹ 150 each as per Board's Resolution No. . . . dated . . .)	300	300
Dec. 31	Debenture Interest A/c Dr. To Bank A/c (Being interest on debentures paid upto 31st December)	22.50	22.50
	15% Partly Convertible Debenture A/c Dr. To Equity Share Capital A/c (Being the conversion of Part A of 2,00,000 PCD into 10,00,000 equity shares of ₹ 10 each as per Board's Resolution No. . . . dated . . .)	100	100
	Statement of Profit and Loss Dr. To Debenture Interest A/c (Being the debenture interest transferred to Statement of Profit and Loss)	22.50	22.50
	Statement of Profit and Loss Dr. To Debenture Redemption Reserve A/c (Being an amount equal to 25% of the Non-convertible portion of the debentures transferred to Debenture Redemption Reserve Account as per the requirement of law)	50	50

Illustration 32

Libra Limited recently made a public issue in respect of which the following information is available :

(a) Number of partly convertible debentures issued 2,00,000; face value and issue price ₹ 100 per debenture.
(b) Convertible portion per debenture 60%, date of conversion on expiry of 6 months from the date of closing the issue.
(c) Date of closure of subscription lists 1.5.2015, date of allotment 1.6.2015, rate of interest on debentures 15% payable from the date of allotment, value of equity share for the purpose of conversion ₹ 60 (face value ₹ 10).
(d) Underwriting commission 2%.

(e) Number of debentures applied for 1,50,000.

(f) Interest payable on debentures half yearly on 30th September and 31st March. Write relevant Journal Entries for all transactions arising out of the above during the year ended 31st March, 2016 (including cash and bank entries).

Solution

In the books of Libra Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
2015 May 1	Bank A/c	Dr.	1,50,00,000	
	To Debentures Application A/c			1,50,00,000
	(Being the application money received for 1,50,000 debentures @ ₹ 100 each)			
June 1	Debentures Application A/c	Dr.	1,50,00,000	
	Underwriters A/c	Dr.	50,00,000	
	To 15% Debentures A/c			2,00,00,000
	(Being the allotment of 1,50,000 debentures to applicants and 50,000 debentures to Underwriters as per Board's Resolution No. . . . dated . . .)			
?	Underwriting Commission A/c	Dr.	4,00,000	
	To Underwriters A/c			4,00,000
	(Being the commission payable to Underwriters @ 2% on ₹ 2,00,00,000)			
?	Bank A/c	Dr.	46,00,000	
	To Underwriters A/c			46,00,000
	(Being the net amount received from Underwriters in settlement of account)			
Sept. 30	Debenture Interest A/c	Dr.	10,00,000	
	To Bank A/c			10,00,000
	(Being the debenture interest paid for 4 months @ 15% on ₹ 2,00,00,000)			
Oct. 31	15% Debentures A/c	Dr.	1,20,00,000	
	To Equity Shares Capital A/c			20,00,000
	To Securities Premium A/c			1,00,00,000
	(Being the conversion of 60% of the debentures into Equity Shares of ₹ 10 each at a premium of ₹ 50 per share as per Board's Resolution No. . . . dated . . .)			
2016 Mar. 31	Debenture Interest A/c (Note 1)	Dr.	7,50,000	
	To Bank A/c			7,50,000
	(Being the debenture interest paid for the 6 months ended on 31.3.2016)			
"	Statement of Profit and Loss ₹ (10,00,000 + 7,50,000)	Dr.	17,50,000	
	To Debenture Interest A/c			17,50,000
	(Being the debenture interest for the year transferred to Statement of Profit and Loss)			
"	Securities Premium A/c	Dr.	4,00,000	
	To Underwriting Commission A/c			4,00,000
	(Being the Underwriting commission adjusted against Share Premium Account)			
	Statement of Profit and Loss (Note 2)	Dr.	20,00,000	
	To Debenture Redemption Reserve A/c			20,00,000
	(Being an amount equal to 25% of the Non-convertible portion of the debentures transferred to Debenture Redemption Reserve Account as per the requirement of law)			

Working Note : (1) Calculation of Debenture Interest for the 6 months ended on 31.3.2016

	₹
On ₹ 1,20,00,000 (60% of ₹ 2,00,00,000) for 1 month @ 15%	1,50,000
On ₹ 80,00,000 (₹ 2,00,00,000 – 1,20,00,000) for 6 months @ 15%	6,00,000
	7,50,000

(2) Non-convertible portion — ₹ 80,00,000. Therefore, the DRR should be equal to 25% of ₹ 80,00,000 = ₹ 20,00,000.

Illustration 33

A company had issued 20,000, 13% convertible debentures of ₹ 100 each on 1st April, 2015. The debentures are due for redemption on 1st July, 2017. The terms of issue of debentures provided that they were redemable at a premium of 5% and also conferred option to the debentureholders to convert 20% of their holding into equity shares (Nominal value ₹ 10) at a price of ₹ 15 per share. Debentureholders holding 2,500 debentures did not exercise the option.

Calculate the number of equity shares to be allotted to the debentureholders exercising the option to the maximum.

Solution **Calculation of Number of Equity Shares to be Allotted** **Cr.**

Particulars	Number of Debentures
Total Number of Debentures	20,000
Less: Debentureholders not opted for conversion	(2,500)
Debentureholders opted for Conversion	17,500
Option for Conversion	20%
Number of Debentures to be Converted (20% of 17,500)	3,500

Redemption value of 3,500 debentures at a premium of 5% = (3,500 × 105) = ₹ **3,67,500**.
Number of equity shares of ₹ 10 each issued on conversion = (3,67,500 ÷ 15) = **24,500 shares**.

Illustration 34

As per the terms of issue of debentures, GGG Ltd. served notice of its intention to redeem its outstanding ₹ 3,00,000, 15% debentures of ₹ 100 each at ₹ 110 and offered the holders the following options :

(a) To convert their holdings into 12% Cumulative Preference Shares of ₹ 20 each at 110%.
(b) To convert their holdings into 15% Debentures at 96%.
(c) To have their holdings redeemed in cash unless otherwise opted.

Holders of 1,800 Debentures opted for (a) and holders of 480 Debentures opted for (b).

Pass the necessary journal entries.

[St. Xaviers' College, Kolkata (Autonomous) — December, 2016]

Solution **In the books of GGG Ltd.**
Journal **Dr.** **Cr.**

Date	Particulars		Dr. ₹	Cr. ₹
	15% Debentures A/c	Dr.	3,00,000	
	Premium on Redemption of Debentures A/c	Dr.	30,000	
	To Debentureholders A/c			3,30,000
	(Being the amount payable to debentureholders for the redemption of 3,000, 15% Debentures of ₹ 100 each @ ₹ 110)			
	Statement of Profit and Loss	Dr.	30,000	
	To Premium on Redemption of Debentures A/c			30,000
	(Being the amount of premium on redemption of debentures transferred to Statement of Profit and Loss)			
	Option (a)		1,98,000	
	Debentureholders A/c	Dr.		1,80,000
	To 12% Cumulative Preference Share Capital A/c			18,000
	(Being the issue of 9,000, 12% Cumulative Preference Shares at a premium of 10% to debentureholders of 1,800 debentures)			
	Option (b)			
	Debentureholders A/c	Dr.	52,800	
	Discount on Issue of Debentures A/c	Dr.	2,200	
	To 15% Debentures A/c			55,000
	(Being the issue of 550 debentures of ₹ 100 each at 4% discount to the debentureholders of 480 debentures)			
	Option (c)			
	Statement of Profit and Loss	Dr.	18,000	
	To Debenture Redemption Reserve A/c			18,000
	(Being the creation of Debenture Redemption Reserve @ 25% of the nominal value of debentures to be redeemed in cash)			
	Debenture Redemption Reserve Investment A/c	Dr.	10,800	
	To Bank A/c			10.800
	(Being the amount invested @ 15% of ₹ 72,000 as per the requirement of the law)			
	Debentureholders A/c	Dr.	79.200	
	To Bank A/c			79.200
	(Being the amount payable to the debentureholders of 720 debentures @ ₹ 110 each)			

	Statement of Profit and Loss Dr. To Discount on Issue of Debentures A/c (Being the amount of discount on issue of debentures transferred to Statement of Profit and Loss)	2,200	2,200
	Debenture Redemption Reserve A/c Dr. To General Reserve A/c (Being the amount transferred to General Reserve	18,000	18,000

Working Notes :

(1) Number of Preference Shares to be Issued

(a) No. of debentureholders opted for preference shares	1,800
(b) Amount payable per debentures	₹ 110
(c) Total amount to be paid (a × b)	₹ 1,98,000
(d) Face value of preference shares	₹ 20
(e) Issue price of preference shares	₹ 22

Number of preference shares to be issued = ₹ 1,98,000 ÷ ₹ 22 = **9,000 shares.**

(2) Number of 15% Debentures to be Issued

(a) No. of existing debentureholders opted for new 15% Debentures	480
(b) Amount payable per existing debentures	₹ 110
(c) Total amount to be paid (a × b)	₹ 52,800
(d) Issue price of new 15% debentures	₹ 96

No. of 15% debentures to be issued = 52,800 ÷ 96 = **550 debentures**.

(3) Cash Payable on Redemption	₹
(a) No. of debentures to be redeemed in cash (3,000 – 1,800 – 480)	720
(b) Cash to be paid per Debenture	₹ 110

Total cash to be paid = 480 × ₹ 110 = ₹ **52,800**.

Illustration 35

The authorised capital of a company consists of 4,00,000 Equity Shares of ₹ 10 each, out of these 1,20,000 shares have been issued as fully paid. The company has also 12,000, 12% debentures of ₹ 12,00,000 redeemable at 102% and interest has been paid up to December 31, 2015.

On that date the balance of the Debenture Redemption Fund Account was ₹ 10,00,000 and that of corresponding Investment Account was also ₹ 10,00,000 (at cost) whose market value was ₹ 9,00,000. It was resolved to redeem the debentures on January 1, 2016 and the holders are given an option to receive payment either wholly in cash or wholly in equity shares at the rate of 8 shares for every ₹ 100 of debentures. 75% of the debentureholders decided to exercise the option for taking shares in repayment and for the rest cash is procured by realising an adequate amount of investments at the prevalent market price.

Show the Journal Entries to give effect to the above transactions.

Solution

In the books of the Company

Journal

Date	Particulars	Dr. ₹	Cr. ₹
2016 Jan. 1	12% Debentures A/c Dr. Premium on Redemption of Debenture A/c Dr. To Debentureholders A/c (Being the amount due to Debentureholders in respect of 12,000 debentures redeemed @ 102%)	12,00,000 24,000	12,24,000
"	Debentureholders A/c (75% of ₹ 12,24,000) Dr. To Equity Share Capital A/c (Note 1) To Securities Premium A/c (Note 1) (Being the conversion of 9,000, 12% Debentures into 72,000 Equity Shares of ₹ 10 each at a premium of ₹ 2.75 per share as per Board's Resolution No. . . . . dated . . .)	9,18,000	7,20,000 1,98,000
"	Bank A/c (25% of ₹ 12,24,000) Dr. Loss on Sale of Investment A/c (10% of ₹ 3,40,000) Dr. To Debenture Redemption Fund Investment A/c (₹ 3,06,000 / 90%) (Being the required amount realised from the sale of investments at 10% loss)	3,06,000 34,000	3,40,000
"	Debentureholders A/c Dr. To Bank A/c (Being the remaining 25% of the Debentureholders paid-off)	3,06,000	3,06,000

"	Debenture Redemption Fund A/c Dr. To Loss on Sale of Investment A/c To Premium on Redemption of Debentures A/c (Being the loss on sale of investment and premium on redemption adjusted against Debenture Redemption Fund Account)	58,000	 34,000 24,000
"	Debenture Redemption Fund A/c (₹ 10,00,000 – 24,000 – 34,000) Dr. To General Reserve A/c (Being the balance of the Debenture Redemption Fund Account transferred to General Reserve)	9,42,000	 9,42,000

Working Note :

	₹
(1) Each debenture of ₹ 100 is to be redeemed at 102%	102
Face value of equity shares to be issued for each debenture (₹ 10 x 8)	80
Balance amount to be treated as premium	22

Premium receivable on each equity share ₹ 22 / 8 = ₹ 2.75 per share.

Therefore, 9,000, 12% Debentures of ₹ 100, redeemable at 102% will be redeemed as under :

	₹
Equity share capital (9,000 × 8 × ₹ 10)	7,20,000
Securities premium (9,000 × 8 × ₹ 2.75)	1,98,000
	9,18,000

Compulsory Conversion of Government Loan / Debentures into Equity Shares

Section 62 of the Companies Act, 2013 states that :

(1) Where any debentures have been issued, or loan has been obtained from any Government by a company, and if that Government considers it necessary in the public interest so to do, it may, by order, direct that such debentures or loans or any part thereof shall be converted into shares in the company on such terms and conditions as appear to the Government to be reasonable in the circumstances of the case even if terms of the issue of such debentures or the raising of such loans do not include a term for providing for an option for such conversion:

Provided that where the terms and conditions of such conversion are not acceptable to the company, it may, within sixty days from the date of communication of such order, appeal to the Tribunal which shall after hearing the company and the Government pass such order as it deems fit.

(2) In determining the terms and conditions of conversion, the Government shall have due regard to the financial position of the company, the terms of issue of debentures or loans, as the case may be, the rate of interest payable on such debentures or loans and such other matters as it may consider necessary.

(3) Where the Government has, by an order made, directed that any debenture or loan or any part thereof shall be converted into shares in a company and where no appeal has been preferred to the Tribunal or where such appeal has been dismissed, the memorandum of such company shall, where such order has the effect of increasing the authorised share capital of the company, stand altered and the authorised share capital of such company shall stand increased by an amount equal to the amount of the value of shares which such debentures or loans or part thereof has been converted into.

KEY POINTS

- According to Section 2 (30) of the Companies Act 2015, debentures includes debenture stock, bonds and any other instruments of the company evidencing a debt, whether constituting a charge on the assets of the company or not.
- A company can issue secured debentures, provided the date of redemption shall not exceed ***10 years*** from the date of issue
- The debentures may be redeemed in one of the following ways :
  (a) By payment in a lump sum at the end of a specified period of time; or
  (b) By payment in annual instalments;
  (c) By purchasing its own debentures in the open market.
  (d) By conversion into shares.
- As per Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014, the company shall create Debenture Redemption Reserve for the purpose of redemption of debentures out of the profit of the company available payment of dividend.

KEY POINTS (contd. ...)

- No DRR is required for debentures issued by :
  (i) All India Financial Institutions (AIFIs) regulated by RBI;
  (ii) Banking Companies;
  (iii) Other Financial Institutions;
  (iv) NBFCs registered with RBI (for privately placed debentures, no DRR is required)
- In respect of Government securities and debentures, the price quoted is Ex-interest unless otherwise stated
- In respect of Non-Government securities and debentures, it is Cum-interest unless otherwise stated.
- As per Rule 8 of the Companies (Share Capital and Debentures) Rules, 2014, all companies (except All India Financial Institutions (AIFIs), Banking Companies and Financial Institutions) including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of debentures.

THEORETICAL QUESTIONS

1. Define debenture as per Companies Act, 2013. What is the time limit for redemption of debentures ?
2. Name three types of companies which do not require to creaste Debenture Redemption Reserve as per the provision of the Companies Act, 2013.
3. What are the different methods of redemption of debentures?
4. Can a company purchase its own debentures? If so, for what purposes?
5. Explain the Sinking Fund Method of redeeming debentures.
6. Write a short note on the Insurance Policy Method of redeeming debenture.
7. What is convertible debenture ? What are the advantages of issuing convertible debentures ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Where a company fails to redeem the debentures on the date of its maturity, the debenture trustees may apply for remedy to
   A the High Court
   B the Ministry of Corporate Affairs
   C the Registrar of Companies
   D the Tribunal
2. Debenture Redemption Reserve is to be created from
   A Securities Premium
   B Capital Reserve not realised in cash
   C Revaluation Reserve
   D Profits available for dividend
3. No Debenture Redemption Reserve is required for debentures issued by
   A public limited companies engaged in infrastructure projects
   B public limited companies manufacturing defence goods
   C banking companies
   D none of the above
4. On 1st April, 2017, Y Ltd. purchased 1,000, 12% debentures of ₹ 100 each @ ₹ 98 (cum-interest). Interest is payable half-yearly on 30th June and 31st December. The date of closing the books of accounts is 31st December every year. The amount to be debited to Debenture Redemption Account is
   A ₹ 98,000
   B ₹ 1,00,000
   C ₹ 95,000
   D none of the above

5. On 1st April, 2017, Y Ltd. purchased 1,000, 12% debentures of ₹ 100 each @ ₹ 98 (ex-interest). Interest is payable half-yearly on 30th June and 31st December. The date of closing the books of accounts is 31st December every year. The amount to be debited to Debenture Redemption Account is
   A ₹ 98,000
   B ₹ 1,00,000
   C ₹ 95,000
   D none of the above

PRACTICAL QUESTIONS

Redemption of Debentures —When there is no Sinking Fund

1. On 31st March 2016, Varun Ltd's Balance Sheet showed 10,000 12% Debentures of ₹ 100 each outstanding. Interest on Debentures is payable on 30th September and 31st March every year. On 1st August, 2016 the company purchased 500 of its own debentures as investment at ₹ 97 ex-interest. Pass Journal Entries for purchase and disposal of own debentures in each one of the following cases : (i) The company cancels all its own debentures on 1st March, 2017. (ii) The company resells all its own debentures at ₹ 105 cum-interest on 1st March, 2017.
   Also show Journal Entries relating to Debenture Interest and Interest on Own Debentures as on 31st March, 2017 in case (i) mentioned above.
2. Sure Ltd. made an issue of 1,000, 6% debentures of ₹ 1,000 each on 1.1.2014 at the issue price of ₹ 960. The terms of issue provided that beginning with 2016, ₹ 40,000 debentures should be redeemed either by purchase in the market or by a lot at par. The expenses of the issue amounted to ₹ 8,000 which were written-off in 2014. In 2015 and 2016, the discount on issue of debentures was written-off equally.
   In 2016, the company purchased ₹ 12,000 debentures at ₹ 940 cum-interest on 30th September and ₹ 20,000 debentures at ₹ 950 ex-interest on 30th November, the expenses being ₹ 800. On 31st December the debentures necessarily to be redeemed were paid-off at par by drawings by lot. Assuming the interest is payable on 30th June and 31st December, make Journal Entries to record the above transactions.
3. Merchants Ltd. issued 10,000, 7.5% debentures of ₹ 1,000 each on 1st July, 2004 at a price of ₹ 990. There was a provision at the time of issue that the debentures can be redeemed either by purchase in the market or by draw of lots. The expenses of issue amounting to ₹ 50,000 were written-off in 2004. In the subsequent year, the entire discount on debentures was written-off.
   In March 2016, the company purchased debentures worth ₹ 10,00,000 at ₹ 975 and in May 2016 worth ₹ 5,00,000 at ₹ 980 cum-interest payable on 30th June 2016. Assuming interest is payable half yearly, i.e., on 30th June and 31st December.
   Prepare the necessary Journal Entries (in 2004 and 2016) recording the above transactions including interest on debentures.
4. Swati Associates Ltd. has issued 10,000, 12% Debentures of ₹ 100 each on 1.1.2014. These debentures are redeemable after 3 years at a premium of ₹ 5 per debenture, interest is payable annually.
   On October 1, 2015, it buys 1,500 Debentures from the market at ₹ 98 per debenture. These are sold away on June 30, 2016 at ₹ 105 per debenture.
   On January 1, 2016 it buys 1,000 debentures at ₹ 104 per debenture from the open market. These are cancelled on April 1, 2016.
   On October 1, 2016 it buys 2,000 debentures at ₹ 106 per debenture from the open market. These debentures along with other debentures are redeemed on 31st December, 2016.
   Prepare the relevant Ledger Accounts showing the above transactions. Working should form part of your answer.
5. X Limited has an authorised capital of ₹ 40,00,000 divided into equity shares of ₹ 100 each. The Balance Sheet of the Company as on 31.12.2016 was as follows :

X Ltd
Balance Sheet as at 31st December, 2016

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	22,00,000
(b) Reserves and Surplus	(2)	24,40,000
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		8,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		5,60,000
(c) Short-term Provisions		—
TOTAL		60,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	34,00,000
(ii) Intangible Assets		—
(b) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments — Investments in own Debentures (Nominal value ₹ 2,00,000)		1,70,000
(b) Inventories		10,00,000
(c) Trade Receivables		13,80,000
(d) Cash and Cash Equivalents		50,000
TOTAL		60,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Share Capital :	
40,000 Equity Shares of ₹ 10 each	40,00,000
Issued and Subscribed Capital :	
22,000 Equity Shares of ₹ 100 each	22,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve	6,80,000
General Reserve	9,20,000
Statement of Profit and Loss	8,40,000
	24,40,000

(3) Fixed Assets

(a) *Tangible Assets :*	
Land and Building	24,00,000
Plant and Machinery	6,00,000
Furniture	4,00,000
	34,00,000

The 12% Debentures were due for payment on 30.6.2017 at a premium of 5%. The company decided to:
(i) issue 6,000 equity shares of ₹ 100 each at ₹ 120 per share;
(ii) redeem out of profits the debentures on 30.6.2017 together with interest for 6 months;
(iii) give an option to the debentureholders to receive either cash or 15% Debentures at par for the amount due.
The holders of ₹ 2,00,000 of the old debentures accepted new debentures worth ₹ 2,16,000. The debentures which the company held as an investment were cancelled.
You are required to prepare necessary Ledger Accounts and to re- draft the company's Balance Sheet.

Redemption of Debenture when there is Sinking Fund

6. On 1st January, 2016, Shiwalik Breweries Ltd. had ₹ 8,00,000, 5% debentures outstanding in its books redeemable on 31st December, 2016.
On 1st January, 2016, the balance of Sinking Fund was ₹ 7,49,000 represented by :
(i) ₹ 1,00,000 own debentures purchased at an average price of ₹ 99; and
(ii) ₹ 6,60,000 nominal value of 3% War Loan.
The amount annually credited to the Sinking Fund was ₹ 28,400.
The interest on debentures was paid by the company every year on 31st December annually.
On 31st December, 2016, the outside investments were realised at 98% and all the outstanding debentures were redeemed on that date. You are required to write-up necessary Ledger Accounts for the year 2016 in the books of the company. ***[Delhi B.Com. (Hons.) — Adapted]***

7. X Ltd. had 1,000, 12% Debentures of ₹ 100 each outstanding on 1.1.2016. There is a Sinking Fund amounting to ₹ 40,000 represented by 9% Bombay Port Trust Bonds, of the face value of ₹ 50,000. Interest on debentures is payable on 30th June and 31st December every year. Interest on bonds is also receivable on the same dates. On

1.4.2016, the company purchases for cancellation 50 of its own debentures at ₹ 96 each cum-interest by selling bonds of the face value of ₹ 5,600. On 31.12.2016, ₹ 10,000 was apportioned for the sinking fund and Bombay Port Trust Bonds were acquired for the amount plus interest on investments. The face value of the bonds purchased was ₹ 15,600. Show the Ledger Accounts.

8. Light Limited had ₹ 12,00,000, 12% Debentures of ₹ 100 each outstanding on 31.3.2016. The following balances also appeared in the books of the company on the same date :

	₹
Sinking Fund (after crediting annual interest on investment and annual instalment of ₹ 30,000)	3,60,000
Sinking Fund Investment — 10% Government Securities (nominal value ₹ 2,40,000)	1,98,000
Own Debentures (nominal value ₹ 1,20,000)	1,14,000

Interest in all cases is payable or receivable on 30th September and 31st March every year. On 1.4.2016, required amount was invested in own debentures bought at ₹ 96 each. On 1.7.2016, own debentures held were cancelled and, in addition, ₹ 1,20,000 of the debentures were purchased in the open market at ₹ 95 each (cum-interest) and cancelled. The amount required was made available by selling 10% Government Securities at ₹ 81(cum-interest) to the nearest ₹ 100 of nominal value. Prepare the necessary Ledger Accounts. ***[C.A. (Inter) — Adapted]***

9. On 1st January 2016, Debenture Account showed a balance of ₹ 1,50,000 in the books of X Ltd. A sinking fund has been created to redeem the debentures which the trustees are empowered to utilise in cancelling the debentures by open market purchase at below par. The Sinking Fund stood at ₹ 48,750 on 1st January 2016 and the entire amount had been invested. During the year 2016, the trustees sold the investments and redeemed the debentures as noted below :

	Investment Cost	Realised	Debentures face value	Cost
28.2.2016 : ₹	18,000	17,562	18,800	17,210
30.9.2016 : ₹	10,000	11,050	11,200	40,980

Interest received on 31.12.2016 was ₹ 1,070 and the annual contribution was ₹ 17,200.
Pass the necessary entries and show how the Ledger Accounts would appear in the books of the company.

10. Hindustan Ltd. issued 50,000, 6% debentures of ₹ 100 each on 1st January 2011. The debentures are redeemable by the creation of a sinking fund. The company had the right to call upon the trustees to apply the sinking fund moneys in purchasing own debentures, if available, below par. The following information is given :
    (a) The annual appropriation is ₹ 50,000.
    (b) Sinking fund balance as on 1st January, 2016 was ₹ 1,81,942 represented by 6% State Loan at cost of ₹ 74,262 (face value ₹ 80,000) and Sinking Fund cash ₹ 7,680. This cash balance together with the annual appropriation of ₹ 50,000 was invested in 6% State Loan. The loan bonds which were purchased cum-interest had a face value of ₹ 60,000.
    (c) On 1st September 2016 sold the State Loan of the face value ₹ 40,000 out of loan held on 1st January 2016 for ₹ 38,000 (ex-interest) and the proceeds were applied in purchasing own debentures (face value ₹ 45,000) ex-interest.
    (d) The debentures purchased are cancelled on 31st December.
    (e) Interest on State Loans is received on 31st March and 30th September.
    (f) Interest on debentures is paid on 30th June and 31st December.
    (g) Debentures outstanding as on 1st January, 2016 were ₹ 4,67,000.

    Make Ledger Entries in the books of the company to give effect to the above.

11. Modern Investors Ltd. issued on January 1, 2015, 20,000 5% debentures of ₹ 100 each redeemable at the option of the company after the second year at ₹ 104 upon given two months notice to the debentureholders. The company purchased the following debentures in the open market:
    On 3.2.2015 ₹ 4,000 nominal cum-interest cost ₹ 4,025.
    On 10.6.2015 ₹ 7,000 nominal ex-interest cost of ₹ 6,915.
    These debentures were retained as investments till July 2, 2016 when these debentures were cancelled. Show the respective ledger accounts as would appear in the books of the company for 2015 and for 2016 upto 3.7.2016. Interest is payable half yearly on June 30 and December 31 every year. Ignore income tax.

12. Prospectus Ltd. issued ₹ 10,00,000, 6% Debentures stock at par on 1.1.2007. Interest was payable on June 30 and December 31, in each year.
    Under the terms of the Debenture Trust the owned stock is redeemable at par. The trust deed obliges the company to pay to the trustees on December 31, 2014, and annually thereafter the sum of ₹ 1,00,000 to be utilised for the redemption and cancellation of an equivalent amount of stock, which is to be selected by drawing lots.
    Alternatively, the company is empowered as from January 1, 2014 to purchase its own debentures in the open market. These debentures must be surrendered to the trustees for cancellation and any adjustments for accrued interest recorded

in the books of account. If in any year the nominal amount of the stock surrendered under this alternative does not amount to ₹ 1,00,000 then the shortfall is to be paid by the company to the trustees in cash on December 31.

The following purchases of stock were made by the company:

Nominal value of stock purchased:

September 30, 2014 ₹ 1,20,000; May 31, 2015 ₹ 75,000; and July 31, 2016 ₹ 1,15,000.

Purchase price per ₹ 100 of stock:

September 30, 2014 ₹ 98; May 31, 2015 ₹ 95 (ex-interest); and July 31, 2016 ₹ 92.

The company fulfilled all its obligations under the trust deed.

Prepare the following Ledger Accounts: (a) Debentures Stock Account; (b) Debentures Redemption Account; and (c) Debenture Interest Account. Note: Ignore costs and taxation.

Conversion of Debenture

13. A Ltd. has issued 2,000, 6% debentures of ₹ 100 each on 1st January, 2007. Interest was payable half-yearly on 30th June and 31st December each year. They are repayable at par on 31st December, 2014 with the option to redeem them at any time after 31st December, 2015 at ₹ 103. On January 1, 2016, the balance in the Debenture Redemption Fund Account stood at ₹ 1,07,000 which was invested outside. On 30th June, 2016 a notice was given for redemption of the above debentures with the option to receive one new 9% debenture of ₹ 100 each at ₹ 98 and ₹ 5 in cash for each 6% debenture in place of ₹ 103 in cash.

    The holders of 1,800 debentures exercised this option and the remaining were paid in cash. The company sold the investments costing ₹ 72,000 for ₹ 87,400. The company completed the redemption. Give necessary Ledger Accounts, affected by the above transactions ignoring interest payments.

14. X Limited had 4,800, 12% Convertible Debentures of ₹ 100 each. On 1.4.2016 the company accounting to the power of articles, made a notice for getting one of the following options to the debentureholders :

    (i) 10% Cumulative Preference Shares at a premium of 10% of ₹ 100 each; (ii) New 12% Debentures at ₹ 10 each at a discount of 10%; (iii) cash at par value.

    Debentureholders holding 2,200 debentures took the first option, 1,800 debentureholders the second option and the balance third option. Show Journal Entries to record the above transactions.

Guide to Answers

Multiple Choice

1. D; 2. D; 3. C; 4. C; 5. A.

Practical Questions

1. **Profit on cancellation of own debentures ₹ 1,500.**

2. **Profit on cancellation ₹ 1,100. Interest on own debentures ₹ 280.**

4. **Loss on cancellation of own debentures (₹ 4,000 + 12,000) ₹ 16,000. It is assumed that all transactions are ex-interest.**

5. **Balance Sheet : Fixed assets ₹ 34,00,000; Current assets : ₹ 23,89,000; Bank ₹ 2,98,000; Total ₹ 60,78,000. Equity share capital ₹ 28,00,000; Securities premium ₹ 80,000; 15% debentures ₹ 2,16,000; Capital reserve ₹ 7,10,000; General reserve ₹ 17,12,000; Sundry creditors ₹ 5,60,000; Total ₹ 60,78,000.**

6. **Profit on cancellation ₹ 1,000; Loss on sale of investment ₹ 3,200; Transferred to General reserve ₹ 8,00,000.**

7. **Profit on cancellation ₹ (5,000 – 4,650) = ₹ 350. Profit on sale of investment ₹ 194.**
Balance of Sinking Fund on 31.12.2016 ₹ 49,316.
Balance of Sinking Fund Investment on 31.12.2016 ₹ 49,642.

8. **Amount to be invested in own debentures on 1.4.2016 — ₹ 1,91,200 (₹ 1,20,000 + 71,200).**
Loss on sale of investment ₹ 5,632; Profit on cancellation of debentures – ₹ 8,848 + 9,600 = ₹ 18,448.
Balance of Sinking Fund Account on 31.3.2017 — ₹ 92,344.
Balance of Sinking Fund Investment Account on 31.3.2017 — ₹ 81,840.

9. **Balance of : Debentures Account ₹ 1,20,000; Sinking fund investment account : ₹ 20,750; Sinking fund account ₹ 39,442; Profit on sale of investment ₹ 1,050; Annual contribution ₹ 17,200.**

10. **Cost of 6% State loan purchased on 1.1.2016 — ₹ 56,780. Profit on cancellation of own debentures — ₹ 6,450; Profit on sale of investments — ₹ 869. Balance of Sinking Fund Amount on 31.12.2016 — ₹ 1,52,761. Balance of 6% State loan on 3112.2016 — ₹ 93,911. Balance of Sinking Fund Cash Account on 31.12.2016 — ₹ 7,200.**

12. **It has been assumed that debentures purchased for immediate cancellation.**
(i) Profit on cancellation of debentures on 30.9.2014 = ₹ 4,200.
(ii) Profit on cancellation of debentures on 31.5.2015 = ₹ 3,750.
(iii) Profit on cancellation of debentures on 31.7.2016 = ₹ 9,775.
(iv) Debenture interest debited to Statement of Profit and Loss — 2014 : ₹ 58,200; 2015 : ₹ 50,175; 2016 : ₹ 43,925.

8

Company Final Accounts

Introduction

One of the norms of modern business dictates all business entities to prepare a set of financial statements with a two-fold purpose — for assessing periodically profits earned and for getting conversant with the financial position of the business concern in question on a specified date. Joint stock companies, simply referred to as companies in India, are no exception to this prescription.

A Profit and Loss Account and a Balance Sheet are essential for all business concerns except the single-ownership ones. In the case of joint stock companies, the Companies Act, 2013, further prescribes books of Account to be maintained and lays down the format and content of financial statements to be made. In addition, the accounts should be statutorily audited by external/s who are called Auditor/s — person or persons legally qualified to do the work. It is the auditor's duty to submit a report in the prescribed format for the shareholders' to see.

Since the introduction of the limited liability system, it has become procedural to appoint a board of directors, through election by the shareholders, which board is supposed to protect and promote their interest to the best of its ability. However, a complete reliance on the board of directors may not be an adequate safeguard for shareholders' interest.

The Companies Act, therefore, prescribes a few provisions under which financial statements are to be prepared and presented. The purpose is to lay before the shareholders adequate information for enabling them to judge the performance of the company and, thus, the role of the directors during a specified period, called the 'accounting period'.

As the preparation of the financial statements of a company requires the observation of the legal prescriptions, it acquires much importance for the shareholders in their efforts to assess the business unit's health.

Annual Accounts

As per the provisions of Section 129(2) of the Companies Act, 2013, at every annual general meeting of a Company, the Board of Directors of the Company, shall lay before such meeting, financial statements for the year.

In this respect, it should be noted that the Annual General Meeting (AGM) should take place within six months from the date of closing of the financial year.

Section 2(40) of the Companies Act, 2013 states that :

"financial statement" in relation to a company, includes—

(i) a balance sheet as at the end of the financial year;

(ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(iii) cash flow statement for the financial year;

(iv) a statement of changes in equity, if applicable; and

(v) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement;

Section 2(41) of the Companies Act, 2013 states that :

"***Financial Year***", in relation to any company or body corporate, means the period ending on the 31st day of March every year, and where it has been incorporated on or after the 1st day of January of a year, the period ending on the 31st day of March of the following year, in respect whereof financial statement of the company or body corporate is made up:

Provided that on an application made by a company or body corporate, which is a holding company or a subsidiary of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Tribunal may, if it is satisfied, allow any period as its financial year, whether or not that period is a year:

Provided further that a company or body corporate, existing on the commencement of this Act, shall, within a period of ***two years*** from such commencement, align its financial year as per the provisions of this clause;

Books of Account to be kept by Company

Section 128 of the Companies Act, 2013 provides that every company shall prepare and keep at its Registered Office books of account and other relevant books and papers and financial statements for every financial year which give ***a true and fair view*** of the state of affairs of the company, including that of its branch office(s), if any, and explain the transactions effected both at the registered office and its banches and such books shall be kept on accrual basis and according to double entry system of accounting.

As per the provision of Section 2(13) "***books of accounts***" includes record maintained in respect of—

(i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;

(ii) all sales and purchases of goods and services of the company;

(iii) the assets and liabilities of the company; and

(iv) the items of cost as may be prescribed under Section 148 in the case of a company which belongs to any class of companies specified under that section.

To satisfy the different requirements of the Companies Act, generally the following books of account are maintained by the companies:

1. ***Cash Book*** to record cash and bank transactions, discounts allowed and received.
2. ***Purchases Day Book*** to record credit purchases.
3. ***Sales Day Book*** to record credit sales.
4. ***Returns Inwards Book*** or ***Sales Returns Book*** to record goods returned by customers.
5. ***Returns Outwards Book*** or ***Purchases Returns Book*** to record goods returned by the company to suppliers.
6. ***Bills Receivable Book*** to record the details of Bills receivable.
7. ***Bills Payable Book*** to record the details of Bills payable.
8. ***Journal Proper*** to record opening entries, closing entries, adjustment entries and such residual transactions for which there is no separate book of primary entry.
9. ***General Ledger*** showing all accounts other than the accounts of customers and suppliers.
10. ***Debtors' Ledger*** or ***Customers' Ledger*** showing accounts of customers.
11. ***Creditors' Ledger*** or ***Suppliers' Ledger*** showing accounts of suppliers.

Statutory Books

As per the provision of different Sections of the Companies Act, 2013, the following records are also to be maintained in addition to the above books of account :

1. Company's Register of Charges [Section 85].
2. Register of members, debentureholders and other security holders [Section 88].
3. Register of investments not held in the company's name [Section 187].
4. Register of directors and key managerial personnel and their shareholding [Section 170].
5. Register of giving loans or giving a guarantee or providing security [Section 186].
6. Register of contracts or arrangements in which directors are interested [Section 189].
7. Register of fixed deposits.

Annual Return

As per the provision of Section 92 of the Companies Act, 2013, every company shall prepare a return (hereinafter referred to as the annual return) in the prescribed form (No. MGT 7) containing the particulars as they stood on the close of the financial year regarding**—**

(a) its registered office, principal business activities, particulars of its holding, subsidiary and associate companies;
(b) its shares, debentures and other securities and shareholding pattern;
(c) its indebtedness;
(d) its members and debenture-holders along with changes therein since the close of the previous financial year;
(e) its promoters, directors, key managerial personnel along with changes therein since the close of the previous financial year;
(f) meetings of members or a class thereof, Board and its various committees along with attendance details;
(g) remuneration of directors and key managerial personnel;
(h) penalty or punishment imposed on the company, its directors or officers and details of compounding of offences and appeals made against such penalty or punishment;
(i) matters relating to certification of compliances, disclosures as may be prescribed;
(j) details, as may be prescribed, in respect of shares held by or on behalf of the Foreign Institutional Investors indicating their names, addresses, countries of incorporation, registration and percentage of shareholding held by them; and
(k) such other matters as may be prescribed, and signed by a director and the company secretary, or where there is no company secretary, by a company secretary in practice:

Provided that in relation to One Person Company and small company, the annual return shall be signed by the company secretary, or where there is no company secretary, by the director of the company.

Signature and Certification of Annual Report

The annual return, filed by a listed company or, by a company having such paid-up capital and turnover as may be prescribed, shall be certified by a company secretary in practice in the prescribed form, stating that the annual return discloses the facts correctly and adequately and that the company has complied with all the provisions of this Act.

An extract of the annual return in such form as may be prescribed shall form part of the Board's report.

Every company shall file with the Registrar a copy of the annual return, within ***sixty days*** from the date on which the annual general meeting is held or where no annual general meeting is held in any year within sixty days from the date on which the annual general meeting should have been held together with the statement specifying the reasons for not holding the annual general meeting, with such fees or additional fees as may be prescribed, within the time as specified in the Act.

Manner of Books of Account to be kept in Electronic Mode

Rule 3 of the Company (Accounts) Rules, 2014 states that :

(1) The books of account and other relevant books and papers maintained in electronic mode shall remain accessible in India so as to be usable for subsequent reference.

(2) The books of account and other relevant books and papers referred to in sub-rule (1) shall be retained completely in the format in which they were originally generated, sent or received, or in a format which shall present accurately the information generated, sent or received and the information contained in the electronic records shall remain complete and unaltered.

(3) The information received from branch offices shall not be altered and shall be kept in a manner where it shall depict what was originally received from the branches.

(4) The information in the electronic record of the document shall be capable of being displayed in a legible form.

(5) There shall be a proper system for storage, retrieval, display or printout of the electronic records as the Audit Committee, if any, or the Board may deem appropriate and such records shall not be disposed of or rendered unusable, unless permitted by law:

Provided that the back-up of the books of account and other books and papers of the company maintained in electronic mode, including at a place outside India, if any, shall be kept in servers physically located in India on a periodic basis.

(6) The company shall intimate to the Registrar on an annual basis at the time of filing of financial statement-

(a) the name of the service provider;

(b) the internet protocol address of service provider;

(c) the location of the service provider (wherever applicable);

(d) where the books of account and other books and papers are maintained on cloud, such address as provided by the service provider.

Explanation.- For the purposes of this rule, the expression "electronic mode" includes ‘‘electronic form’’ as defined in clause (r) of sub-section (1) of section 2 of Information Technology Act, 2000 (21 of 2000) and also includes an electronic record as defined in clause (t) of sub-section (1) of section 2 of the Information Technology Act, 2000 (21 of 2000) and ‘‘books of account ’’ shall have the meaning assigned to it under the Act.

Forms and Contents of Balance Sheet and Statement of Profit and Loss

Section 129(1) states that :

The financial statements shall give ***a true and fair view*** of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in ***Schedule III:***

Provided that the items contained in such financial statements shall be in accordance with the ***accounting standards***:

Provided further that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company:

Transitional Provisions with Respect to Accounting Standard

Rule 7 of the Company (Accounts) Rules, 2014 states that :

(1) The standards of accounting as specified under the Companies Act, 1956 (1 of 1956) shall be deemed to be the accounting standards until accounting standards are specified by the Central Government under section 133.

(2) Till the National Financial Reporting Authority is constituted under section 132 of the Act, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India in consultation with and after examination of the recommendations made by the National Advisory Committee on Accounting Standards.

Points to be Noted

1. ***Every Statement of Profit and Loss and Balance Sheet of the company shall comply with the accounting standards.***
2. ***Where compliance with Accounting Standards necessitates any change in the treatment or disclosure, the same should be made and the requirements of the 'Schedule III' stands modified accordingly.***
3. ***Where the Statement of Profit and Loss and the Balance Sheet of the company do not comply with the accounting standards, such companies shall disclose in its Statement of Profit and Loss and Balance Sheet, the following, namely: (a) the deviation from the accounting standards; (b) the reasons for such deviation; and (c) the financial effect, if any, arising due to such deviation.***

   For the purposes of this section, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949) as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards.

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

Authentication of Financial Statements

Section 134(1) of the Companies Act, 2013 states that :

The financial statement, including consolidated financial statement, if any, shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the chairperson of the company where he is authorised by the Board or by two directors out of which one shall be managing director and the Chief Executive Officer, if he is a director in the company, the Chief Financial Officer and the company secretary of the company, wherever they are appointed, or in the case of a One Person Company, only by one director, for submission to the auditor for his report thereon.

Circulation of Financial Statements

Section 134(7) and (8) of the Companies Act, 2013 states that :

A signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of—

(a) any notes annexed to or forming part of such financial statement;

(b) the auditor's report; and

(c) the Board's report referred to in sub-section (3).

If a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Copy of Financial Statements to be Filed with Registrar of Companies

As per the provision of Section 137(1) of the Companies Act, 2013 a copy of the financial statements, including consolidated financial statement, if any, along with all the documents which are required to be or attached to such financial statements under this Act, duly adopted at the annual general meeting of the company, shall be filed with the Registrar within thirty days of the date of annual general meeting in such manner, with such fees or additional fees as may be prescribed within the time specified under section 403:

Rule 12(1) of the Companies (Accounts) Rules, 2014 states that every company shall file the financial statements with Registrar together with Form AOC-4.

Provided that where the financial statements under sub-section (1) are not adopted at annual general meeting or adjourned annual general meeting, such unadopted financial statements along with the required documents under sub-section (1) shall be filed with the Registrar within thirty days of the date of annual general meeting and the Registrar shall take them in his records as provisional till the financial statements are filed with him after their adoption in the adjourned annual general meeting for that purpose:

Provided further that financial statements adopted in the adjourned annual general meeting shall be filed with the Registrar within thirty days of the date of such adjourned annual general meeting with such fees or such additional fees as may be prescribed within the time specified under section 403:

Provided also that a One Person Company shall file a copy of the financial statements duly adopted by its member, along with all the documents which are required to be attached to such financial statements, within one hundred eighty days from the closure of the financial year:

Provided also that a company shall, along with its financial statements to be filed with the Registrar, attach the accounts of its subsidiary or subsidiaries which have been incorporated outside India and which have not established their place of business in India.

Filing of Financial Statements in XBRL Format

Rule 12(2) of the Companies (Accounts) Rules, 2014 states that :

The class of companies as may be notified by the Central Government from time to time, shall mandatorily file their financial statement in Extensible Business Reporting Language (XBRL) format and the Central Government may specify the manner of such filing under such notification for such class of companies.

Explanation.- For the purposes of this sub-rule, the term ''Extensible Business Reporting Language'' means a standardised language for communication in electronic form to express, report or file financial information by companies under this rule.

[See Appendix—1 for details.]

Schedule III of the Companies Act, 2013

Some of the developments of the past century like globalisation and support to free economy, advancement of information technology in every sphere of life including that of accounts and finance and the worldwide web has changed our perception of traditional business habits and techniques. The present day world is a 'high-tech' world. It demands accurate analysis of all financial indicators, which are of utmost importance for success of any business venture.

Since the introduction of old / pre-revised Schedule VI of the Companies Act, 1956, there has been a drastic change in economic environment of India. Many new companies have been formed to do business in non-traditional areas. The nature of their assets and liabilities are quite different from that of traditional business. ***For example***, the main assets of a bio-technology company and telecommunication company are intangible in nature, e.g., licence fees for bandwidth. It is worth mentioned here that there was no separate heading for '***Intangible Assets***' in the old / pre-revised Schedule VI. of the Companies Act, 1956

Similarly, there were many items in the old / pre-revised Schedule VI of the Companies Act, 1956 under '***Fixed Assets***' like Railway Sidings, Livestock, etc., which are very uncommon now-a-days for most of the Companies. Again, some of the disclosure requirements of old / pre-revised Schedule VI such as licensed capacity, CIF value of imports etc., are not relevant in present days context. The old / pre-revised Schedule VI was not adequate to reflect changes in the corporate financial reporting and a major structural changes of the Schedule VI was overdue.

The Companies Act, 2013 along with different ***Schedules*** is an attempt in modernising and simplifying the presentation and making it more relevant to the present day needs of stakeholders.

Main Features of Schedule III

1. The Schedule III has been framed as per the existing ***non-converged*** Indian Accounting Standards. It has no connection with the converged Indian Accounting Standards (Ind-AS) or IFRS.
2. If there is conflict between Accounting Standards and Schedule III, in respect of treatment of an item or disclosure of anything, the provision of Accounting Standards will prevail.
3. The disclosure requirements specified in Part I and Part II of this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards.
4. Additional disclosures specified in Accounting Standards shall be made in the ***Notes to Accounts***.
5. Broad and significant items to be presented on the face of the financial statements. Details to be given in the ***Notes to Accounts***.

6. The Schedule III prescribe a '***Vertrical Format***' for presentation of Balance Sheet. There is no scope for Horizontal format for presenting Balance Sheet in the Schedule III. The contents and structure are totally different from Schedule VI of the Companies Act, 1956.
7. The Schedule III also prescribes a Vertical Format for presentation of Profit and Loss Account. However, the name has been changed to '***Statement of Profit and Loss***'.
8. All assets and liabilities are to be classified into '***Current***' and '***Non-current***'.
9. Calculation of managerial remuneration not required to be shown.
10. The Cash Flow Statement, where required, are to be prepared as per AS—3 : Cash Flow Statements.

Structure of Schedule III

PART I – Form of BALANCE SHEET

Name of the Company ....

Balance Sheet as at ....(₹ in ....)

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) **Shareholders' Funds**			
(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			
(2) **Share Application Money Pending Allotment**			
(3) **Non-current Liabilities**			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long-term provisions			
(4) **Current Liabilities**			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
(1) **Non-current Assets**			
(a) Fixed assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long-term loans and advances			
(e) Other non-current assets			
(2) **Current Assets**			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
TOTAL			

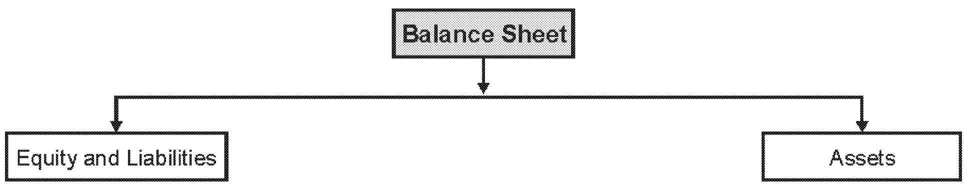
Some Important Points in Respect of Preparation of Balance Sheet

1. The name of the Company is to be written at the top. The date of the Balance Sheet is to be written in the ***next line***.
2. The previous year figures are to be shown along with the current year figures (except in the case of first financial statements laid before a Company after its incorporation). In the '***Notes to Accounts***' also, the previous year figures as well as current year figures are to be given.

3. The companies with turnover of less than INR 100 crores can round off the figures in the financial statements to the nearest lakhs or millions or decimals thereof apart from to the nearest hundreds or thousands or decimals thereof.
4. The companies with turnover of INR 100 crores or more may round off to the nearest lakhs, millions or crore or decimals thereof.
5. Only main items in aggregate are to be shown on the **face of the Balance Sheet.**
6. Notes to Accounts are part and parcel of the Financial Statements. It will include narrative descriptions or disaggregation of items recognised in the financial statements. The items like contingent liabilities, commitments, guarantees etc., are to be disclosed in the Notes to Accounts.
7. There is no separate broad heading of '***Miscellaneous Expenditure***' (or debit balance of the Profit and Loss Account) in the Schedule III. All those items (e.g., discounts on issue of shares and preliminary expenses) are to be adjusted against '***Reserve and Surplus***' in the Schedule III or these can be shown as negative figures under 'Reserve and Surplus'.
8. All assets are to be classified into '***Non-Current Assets***' and '***Current Assets***' (Detail discussions have been made after few pages).
9. All liabilities are to be classified into '***Non-Current Liabilities***' and '***Current Liabilities***' (detail discussions have been made after few pages).

Schedule III at a Glance

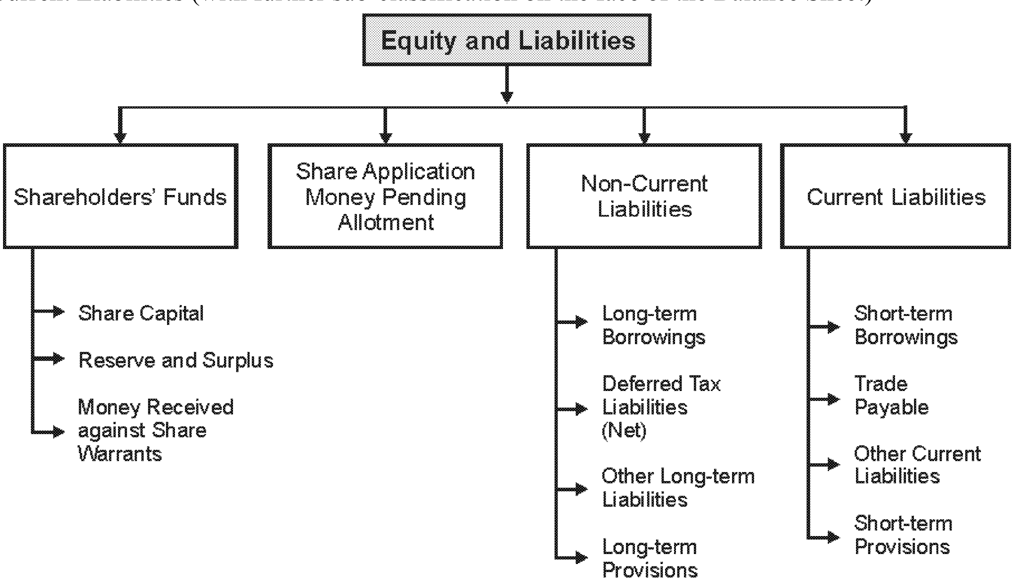
Part I : Form of Balance Sheet and Part II : Form of Statement of Profit and Loss



I. Equity and Liabilities

Equity and liabilities have been divided into ***four*** main headings. These are :

1. Shareholder's Funds (with further sub-classification on the face of the Balance Sheet)
2. Share Application Money Pending Allotment
3. Non-Current Liabilities (with further sub-classification on the face of the Balance Sheet)
4. Current Liabilities (with further sub-classification on the face of the Balance Sheet)

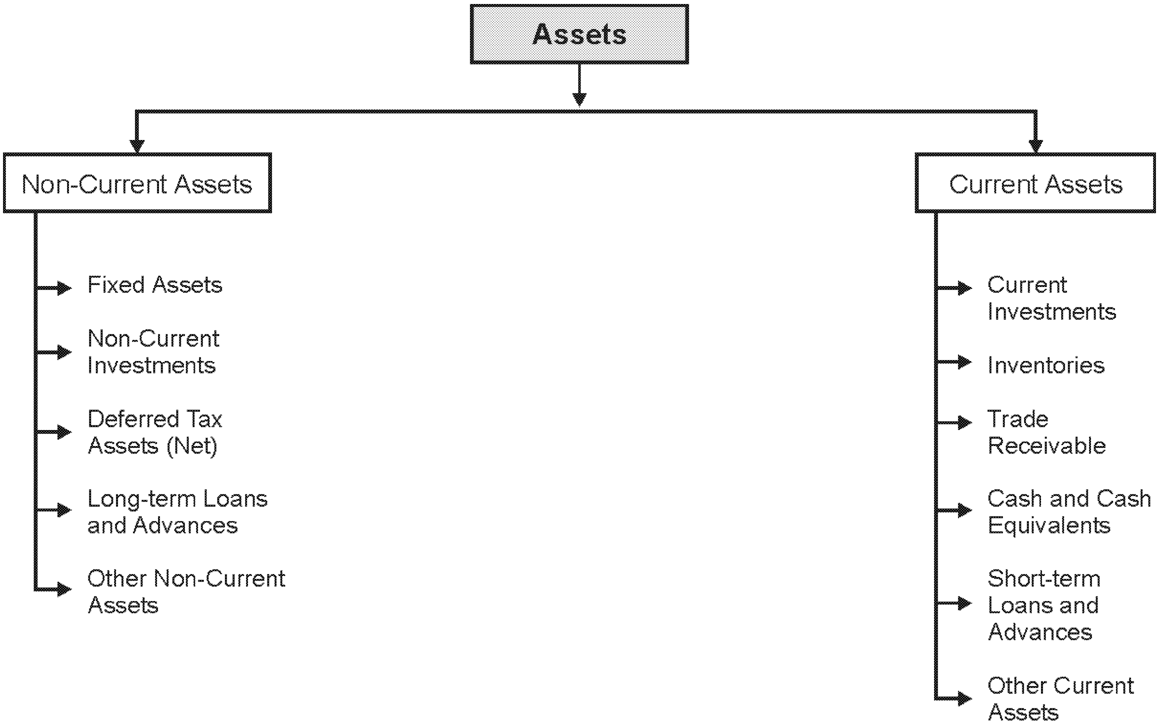


II. Assets

Assets have been divided into ***two*** main headings. These are :

(a) Non-Current Assets (with further sub-classification on the face of the Balance Sheet)

(b) Current Assets (with further sub-classification on the face of the Balance Sheet)



1. Shareholder's Funds

There are three items under 'Shareholder's Funds' :

(i) Share Capital;

(ii) Reserve and Surplus; and

(iii) Money Received against Share Warrants

All the above items are shown on the face of the Balance Sheet in aggregate. The details are shown in the 'Notes to Accounts'. Details of each item are shown below :

(i) Share Capital

In the 'Schedule III' the disclosures in respect to share capital is much more than the 'Pre-Revised Schedule VI'. These disclosures are to be made in the '***Notes to Accounts***'. The following aspects are to be disclosed for each class of share capital (different classes of preference shares are to be treated separately) :

(a) the number and amount of shares authorized;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and end of the reporting period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
- Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
- Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
- Aggregate number and class of shares bought back.

(j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(l) forfeited shares (amount originally paid up)

Points to be Noted

(1) Unlike the Pre-revised Schedule VI there is no requirement to disclose the amount 'called-up' per share.

(2) Calls unpaid are required to be disclosed, stating separately the aggregate value of calls unpaid by directors and officers of the Company.

(3) The name of the shareholders who are holding more than 5% shares of each class are to be disclosed. The actual number of shares held is also to be disclosed. The above percentage and number of shares may be computed with reference to the position as at the end of the financial year.

(4) The amount of 'Calls paid in advance' does not form part of the paid-up capital. Under Schedule III, calls in advance should be disclosed under 'other current liabilities'. The amount of interest, if any, on such advance should also be shown under 'other current liabilities.

Notes to Accounts related to Share Capital has been shown below taking from the Annual Report of Reliance Industries Ltd. for the year 2014-15. It will help the students to understand the above discussed matter in respect of Share Capital.

Real Life Focus

Reliance Industries Ltd.
Notes on Financial Statements for the Year ended 31st March, 2015

The previous year figures have been regrouped / reclassified wherever necessary to conform to the current year presentation.

(₹ in crore)

1. SHARE CAPITAL			As at 31st March, 2015	As at 31st March, 2014
Authorised Share Capital :				
500,00,00,000 (500,00,00,000)	Equity Shares of ₹ 10 each		5,000	5,000
100,00,00,000 (100,00,00,000)	Preference Shares of ₹ 10 each		1,000	1,000
			6,000	6,000
Issued, Subscribed and Paid up :				
323,56,88,765 (323,19,01,858)	Equity Shares of ₹ 10 each fully paid up		3,236	3,232
	Less : Calls in arrears - by others [₹ 3,113 (Previous year ₹ 3,113)]		– 3,236	– 3,232
TOTAL			3,236	3,232

1.1	45,04,27,345 (45,04,27,345)	Shares were allotted on conversion / surrender of Debentures and Bonds, conversion of term Loans, exercise of Warrants, against Global Depository Shares (GDS) and re-issue of Forfeited Equity Shares, since inception.
1.2	17,18,83,624 (17,18,83,624)	Shares held by subsidiaries, which were allotted pursuant to the Schemes of Amalgamation sanctioned by the Hon'ble High Courts in the previous years, do not have voting rights and are not eligible for Bonus Shares.
1.3	4,62,46,280 (4,62,46,280)	Shares were bought back and extinguished in the last five years.

1.4 The details of Shareholders holding more than 5% shares :

Name of the Shareholder	**As at 31st March, 2015**		As at 31st March, 2014	
	No. of Shares	**% Held**	No. of Shares	% Held
Life Insurance Corporation of India	**29,69,44,782**	**9.18**	26,35,20,679	8.15

1.7 The reconciliation of the number of shares outstanding is set out below :

Particulars	**As at 31st March, 2015**	As at 31st March, 2014
	No. of Shares	No. of Shares
Equity Shares at the beginning of the year	**323,19,01,858**	322,86,63,382
Add: Shares issued on exercise of Employee Stock Options	**37,86,907**	32,38,476
Equity Shares at the end of the year	**323,56,88,765**	323,19,01,858

1.6 The Company has reserved issuance of 12,67,18,207 (Previous year 13,05,05,114) Equity Shares of ₹ 10 each for offering to eligible employees of the Company and its subsidiaries under Employees Stock Option Scheme (ESOS). During the year, the Company has granted 45,419 options which includes 21,367 options at a price of ₹ 936 per option, 13,052 options at a price of ₹ 961 per option and 11,000 options at a price of ₹ 843 per option plus all applicable taxes, as may be levied in this regard on the Company (Previous year 71,866 options which includes 60,866 options at a price of ₹ 860 per option and 11,000 options at a price of ₹ 880 per option plus all applicable taxes, as may be levied in this regard on the Company) to the Eligible Employees. The options would vest over a maximum period of 7 years or such other period as may be decided by the Human Resources, Nomination and Remuneration Committee from the date of grant based on specified criteria.

(ii) Reserve and Surplus

(i) Reserves and Surplus shall be classified as:
- (a) Capital Reserves ;
- (b) Capital Redemption Reserve;
- (c) Securities Premium Reserve;
- (d) Debenture Redemption Reserve;
- (e) Revaluation Reserve;
- (f) Share Options Outstanding Account;
- (g) Other Reserves — (specify the nature and purpose of each reserve and the amount in respect thereof);
- (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

  (Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Points to be Noted

1. ***In the pre-revised Schedule VI, the 'debit' balance of Profit and Loss Account used to be shown under 'Miscellaneous Expenditure' on the assets side of the Balance Sheet (or under application of funds in the vertical form of Balance Sheet).***
   In the 'Schedule III', it has been specifically provided that debit balance of Statement of Profit and Loss shall be shown as negative figure under 'Surplus'.
2. ***'Pre-revised Schedule VI' did not specify the manner of disclosure of 'Share Option Outstanding Account'. However, the 'Schedule III 'requires that the credit balance in the 'Stock Option Outstanding Account' is to be disclosed in the Balance Sheet as a line item under 'Reserve and Surplus' heading.***

(iii) Money Received Against Share Warrants

The 'Schedule III' specifically requires that 'Money Received Against Share Warrants' to be disclosed as a separate line item under '***Shareholders' Funds***'.

Meaning and Purpose of Share Warrants

Occasionally, companies offer share warrants to promoters or emoployees as incentive. In majority cases, share warrants are attached' to newly issued debentures / bonds or preference shares to attract the investors. The idea is that the issuing company can pay lower rate of interest on the debentures / bonds by offering share warrants as part of the deal. Share warrants permit the holder to purchase the shares of the company at a pre-determined price (which is lower than the market price) within a certain period.

It is to be noted that the holder of the share warrants is not bound to purchase the shares of the company. He may opt out. Those who are interested to purchase shares will have to pay money within the time limit. Money received in this respect will be shown as a separate line item. In future, when shares will be allotted, a portion will be added with the share capital (the face value) and remaining portion will be treated as premium to be shown under 'Reserve and Surplus'.

In this context, it is important to note the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 as amended upto 24.03.2015. Regulation 4, sub-reguation 3 states that :

Warrants may be issued along with public issue or rights issue of specified securities subject to the following :

(a) the tenure of such warrants shall not exceed eighteen months from their date of allotment in the public / rights issue;

(b) not more than one warrant shall be attached to one specified security;

(c) the price or conversion formula of the warrants shall be determined upfront and at least 25% of the consideration amount shall also be received upfront;

(d) in case the warrant holder does not exercise the option to take equity shares against any of the warrants held by him, the consideration paid in respect of such warrant shall be forfeited by the issuer.

2. Share Application Money Pending Allotment

As per 'Schedule III', share application money pending allotment to be shown in a separate heading under '***Equity and Liability***'. It is to be noted that it has not been included under 'Shareholders' Fund'. In the 'Notes to Accounts', the company should disclose the terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted.

In the pre-revised Schedule VI there was no requirement for disclosure of 'share application money pending allotment'. Previously, it was the practice of many companies to take money from their parent company or others against which shares are not allotted for several years. In some case, money is refunded after a few years without allotting any shares. To prevent this type of malpractice, the 'Schedule III' requires specific disclosures.

3. Non-Current Liabilities

Non-current liabilities are required to be classified under ***four*** sub-heads on the face of the Balance Sheet. These are :

(a) Long-term borrowings
(b) Deferred tax liabilities (Net)
(c) Other long-term liabilities
(d) Long-term provisions

(a) Long-term Borrowings

(i) Long-term borrowings shall be classified as:
  (a) Bonds/debentures.
  (b) Term loans
    - from banks.
    - from other parties.
  (c) Deferred payment liabilities.
  (d) Deposits.
  (e) Loans and advances from related parties.
  (f) Long term maturities of finance lease obligations
  (g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case.

Points to be Noted

1. ***Each category of borrowings should be sub-classified as secured or unsecured. Nature of security shall be specified separately in each case.***
2. ***Only those advances which are in the nature of loans should be disclosed as part of borrowings. Advances received for supply of goods after two or three years will not be included in the borrowings.***
3. ***The 'Schedule III' requires disclosure of the period and amount of continuing default in the repayment of loans and interest as on the Balance Sheet date. In this respect it is to be noted that any default that occurred during the current year but made good before the date of Balance Sheet may not be disclosed.***
4. ***Finance lease obligation should be divided into two parts — current and non-current. Non-current portion will be shown under this heading.***
5. ***Deferred payment liabilities also to be divided into two parts — current and non-current. Non-current portion will be shown under this heading.***

(b) Deferred Tax Liabilities (Net)

As per Schedule -III, the amount of deferred tax liabilities (net of deferred tax assets) is required to be disclosed on the face of the Balance Sheet after 'long-term borrowings'.

It is to be noted that deferred tax liabilities (net) will be classified as non-current in 'total' even where a part thereof is expected to reverse within the period of 12 months.

(c) Other Long-term Liabilities

In the 'Notes to Accounts' other long-term liabilities shall be classified as :

(i) Trade Payable
(ii) Other

(i) ***Trade Payable*** : Amount due on account of goods purchased or services received in the normal course of business which are not current liabilities will be disclosed here. If any portion of the trade payable is expected to be settled within the operating cycle (which may be more than 12 months) it is to be treated as '***current***

liabilities' and is not to be shown here. The acceptances payable beyond operating cycle will be treated as trade payable of non-current nature.

(ii) ***Other*** : Amount payable in respect of statutory obligation, purchase of assets etc., will be shown under this heading.

(d) Long-term Provisions

In the 'Notes to Accounts' long-term provisions should be disclosed as follows :

(i) Provision for Employee Benefits
(ii) Others (specifying nature)

4. Current Liabilities

Current liabilities are required to be classified under ***four*** sub-heads on the face of the Balance Sheet. These are :

(a) Shor-term borrowings
(b) Trade payables
(c) Other current liabilities
(d) Short-term provisions

(a) Short-term Borrowings

(i) Short-term borrowings shall be classified as:
  (a) Loans repayable on demand
    - from banks.
    - from other parties.
  (b) Loans and advances from related parties.
  (c) Deposits.
  (d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case.

Points to be Noted

1. ***Each category of borrowings shall be sub-classified as secured or unsecured. Nature of security shall be specified separately in each case. It is to be noted that when promoters or any other third party have given any personal security for any borrowing by the company, it will not be treated as secured borrowings. However, it should be mentioned in the 'Notes to Accounts'.***
2. ***Only those short-term advances which are in the nature of loan should be disclosed as part of the short-term borrowings. Advances received for supply of goods and services will not be included here.***
3. ***'Loans and Advances from related parties' are required to be shown seperately under each sub-head of 'short-term borrowings'.***
4. ***The 'Schedule III' requires disclosure of the period and amount of continuing default in the repayment of loans and interest as on the Balance Sheet date.***
   In this respect it should be noted that any default that occurred during the current year but made good before the date of Balance Sheet may not be disclosed.

(b) Trade Payables

Amount payable to suppliers for goods and services which are due for payment within the operating cycle will be shown under this heading. Acceptances payable within the operating cycle will also be shown under this heading.

(c) Other Current Liabilities

In the 'Notes to Accounts' other current liabilities shall be sub-classified as follows :

(a) Current maturities of long-term debt;
(b) Current maturities of finance lease obligations;
(c) Interest accrued but not due on borrowings;
(d) Interest accrued and due on borrowings;
(e) Income received in advance;
(f) Unpaid dividends
(g) Application money received for allotment of securities and due for refund and interest accrued thereon.
(h) Unpaid matured deposits and interest accrued thereon
(i) Unpaid matured debentures and interest accrued thereon
(j) Other payables (specify nature).

Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities"

Real Life Focus

Reliance Industries Ltd.
Notes on Financial Statements for the Year ended 31st March, 2015

8. OTHER CURRENT LIABILITIES **(₹ in crore)**

	As at 31st March, 2015		As at 31st March, 2014	
Current maturities of long term debt	8,449		4,459	
Current maturities of finance lease obligations (Refer Note No. 3 and 10.8)	27	8,476	25	4,484
Current maturities of Deferred Payment Liabilities		3		3
Interest accrued but not due on borrowings		254		194
Unclaiming Dividends#		199		175
Application money received and due for refund#		1		1
Unclaimed / Unpaid matured debentures and interest accrued thereon#		1		1
Other Payables*		10,129		5,909
TOTAL		19,063		10,767

\# These figures do not include any amounts, due and outstanding to be credited to Investor Education and Protection Fund except ₹ 15 crore (previous year ₹ 12 crore) which is held in abeyance due to legal cases pending.
* Includes statutory dues, security deposits, creditors for capital expenditure and advance from customers.

(d) Short-term Provisions

Just like long-term provisions, short-term provisions are to be shown in the 'Notes to Accounts' as follows :

(i) Provisions for employee benefits
(ii) Others (specifying nature).

Under 'others' all provisions of short-term nature is to be included other than employee benefits. The following items are generally shown under 'others' :

(i) proposed dividend;
(ii) provision for taxation;
(iii) provision for warranty (current in nature)

Real Life Focus

Reliance Industries Ltd.
Notes on Financial Statements for the Year ended 31st March, 2015

9. SHORT TERM PROVISIONS **(₹ in crore)**

	As at 31st March, 2015	As at 31st March, 2014
	₹	₹
Provisions for Employee Benefits (Refer Note No. 23.1)	237	190
Proposed Dividend	2,944	2,793
Tax on Dividend	615	475
Provision for Wealth Tax	77	60
Other Provisions	981	649
TOTAL	4,854	4,167

Issues Relating to Current / Non-current Classification

In the 'Schedule III' an entity shall present current and non-current assets, and current and non-current liabilities, as separate classification on the face of the Balance Sheet. It is to be noted that for some entities, such as financial institutions, a presentation of assets and liabilities in increasing or decreasing order of liquidity provides information that is reliable and more relevant than a current / non-current presentation. However, the Schedule III does not give such option.

Conditions for Classification of Liabilities as Current Liabilities

The Schedule III states that a liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's ***normal operating cycle***;
(b) it is held primarily for the purpose of being traded;
(c) it is due to be settled within ***twelve months*** after the reporting date; or
(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

Some current liabilities, such as trade payable and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. An entity classifies such operating

An entity shall classify all other liabilities as non-current liabilities.

items as current liabilities even if they are due to be settled more than twelve months after the reporting period.

Liabilities that are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or are held primarily for the purpose of trading are also current liabilities. Thus, current liabilities also include ***curtrent portion of non-current financial liabilities.***

Illustration 1

On 1st May, 2016, M H Ltd took a loan from State Bank of India for ₹ 12,00,000. This is due to be repaid in 16 equal instalments at three monthly intervals. The first repayment was due on 1st August, 2016. All payment to date have been made on due date.

How should the oustanding balance on 31st March, 2017 be reported in the Balance Sheet at that date ? (Ignore interest).

Solution

		₹
(i) Amount payable per instalment = ₹ 12,00,000 ÷ 16		75,000
(ii) Installments paid during 2016-17 = ₹ 75,000 × 3		2,25,000
(iii) Installments to be paid during 2017-18 = ₹ 75,000 × 4		3,00,000
(iv) Installments to be paid during 2018-19 and onwards = ₹ 75,000 × 9		6,75,000
Total loan	12,00,000	
Less: Paid during 2016-17	2,25,000	
Amount outstanding on 31st March, 2017	9,75,000	

In the Balance Sheet of 2016-17 ₹ 3,00,000 will be shown as ***Current Liabilities*** as it s to be paid within 12 months from the date of closing. However, ₹ 6,75,000 will be shown as ***Non-Current Liabilities***.

Solution at a glance :

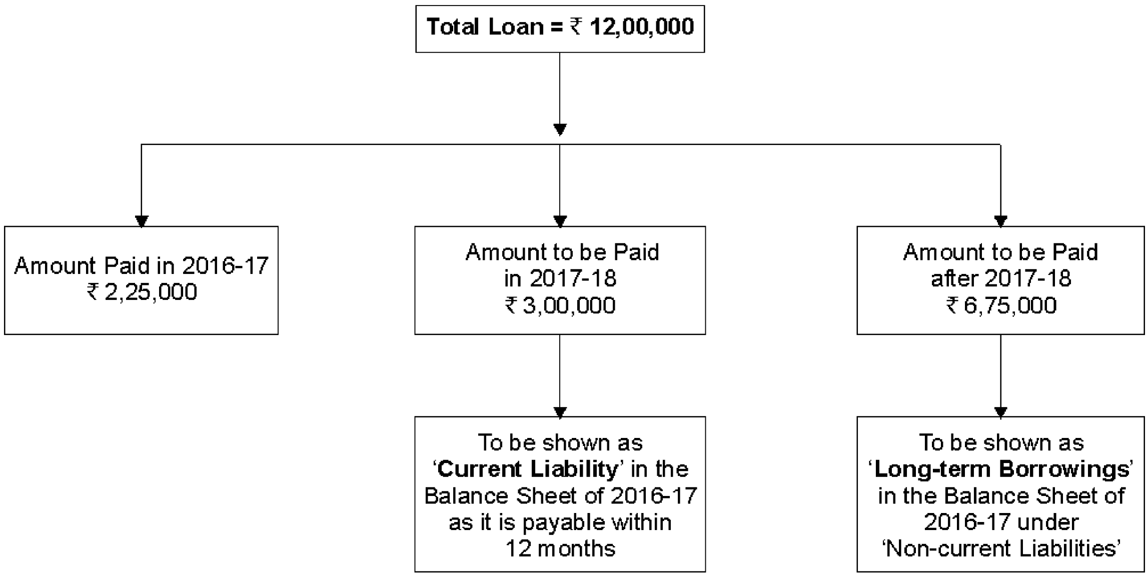


Illustration 2

On 1st April, 2016, H M Co. Ltd,. acquired a Volvo AC Bus at a cost of ₹ 63,60,000 for carrying its staff from railway station to factory office. The purchase was financed through a six year finance lease.Under the lease, an initial payment of ₹ 14,20,000 was made on 1st April, 2016. Five further payments of ₹ 14,20,000 are to be paid on 1st April each year, commencing 1st April, 2017.

H M Co. Ltd. used the sum of digits method to allocate interest to accounting periods. How should the total lease liability (showing current and non current) be reported in the fincnail statements on 31st March, 2017 ?

Solution

Total lease payment (6 × ₹ 14,20,000)	85,20,000
Cost of the bus	63,60,000
Total Interest	21,60,000

Total Lease Liability :	
Cost of bus	63,60,000
Less: Initial payment on 1st April, 2016	14,20,000
	49,40,000
Interest of 2016-17 (5/15 × ₹ 21,60,000)	7,20,000
Balance as at 31st March, 2017	56,60,000

The above amount will be shown in the Balance Sheet as at 31st March, 2017 as follows :

(i) Installment within 12 months from 31st March, 2017 = ₹ 14,20,000 will be shown as **Current Liability.**

(ii) The balance ₹ 42,40,000 (56,60,000 – 14,20,000) will be shown as **Non-Current Liability.**

Conditions for Classification of Assets as Current Assets

The Schedule III states that an asset shall be classified as ***current*** when it satisfies any of the following criteria:

(a) it is expected to be realized in, or is intended for sale or consumption in, the company's ***normal operating cycle***;

(b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within ***twelve months*** after the reporting date; or

(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

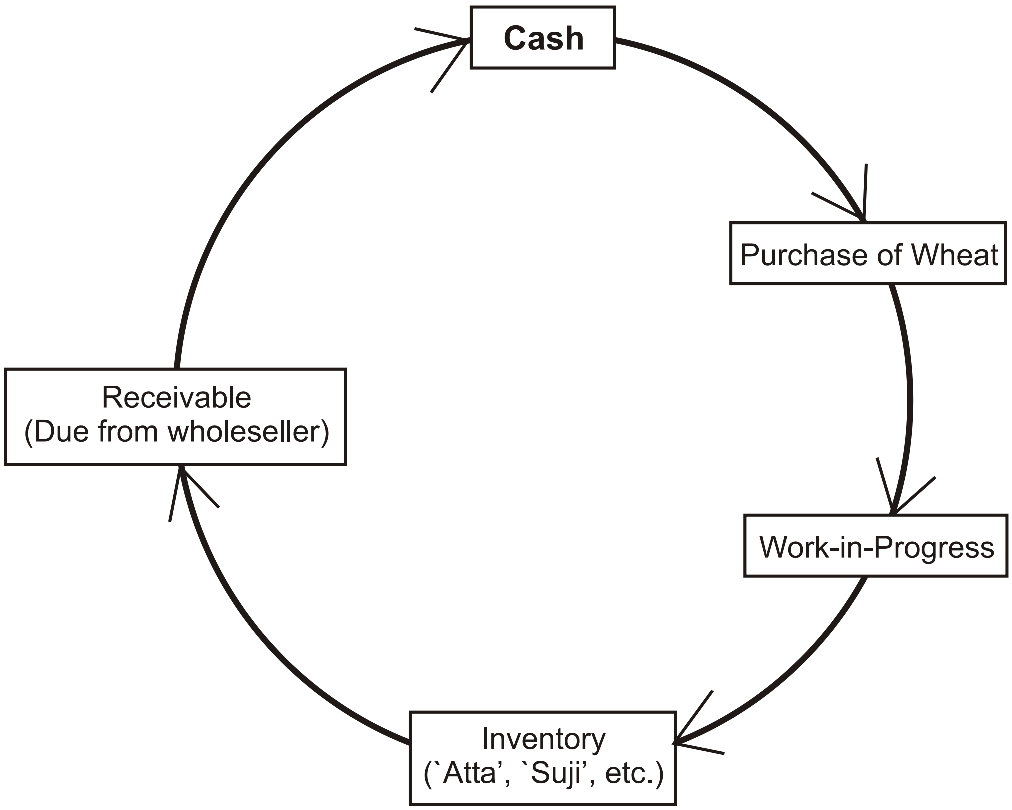
An entity shall classify all other assets as non-current. The term 'non-current' to include tangible, intangible and financial assets of long-term nature.

Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets held primarily for the purpose of trading (examples include some fincnail assets classified as held for trading and the current portion of non-current financial assets).

Meaning of Operating Cycle

The operating cycle of an entity is the process by which the entity converts cash into short-term assets and back into cash as part of its operating activities. For an 'Atta' manufacturing company , this would entail purchasing of wheat from the market / farmers, converting them into 'Atta' and 'Suji' and then selling to the wholesellers or distributors and collecting cash from the wholesellers or distributors.

The ***following diagram*** will show the process :



Illustrative Example

Vatika Ltd. provides the following information :

(i) Raw material stock is held for 3.5 months.

(ii) Processing period is 1 month.

(iii) Finished goods stock are held for 6 months.

(iv) Debtors collection period is 4.5 months.

You are required to compute the operating cycle of Vatika Ltd..

If the trade payable are paid in 14 months, whether these should be classified as 'current liability' or 'non-current liability' ?

Solution

As per Schedule III of the Companies Act, 2013 "An operating cycle is the time between the acquisition of assets or processing and their realisation in cash or cash equivalents."

Therefore, operating cycle of Vatika Ltd. will be computed as follows :

	Months
(i) Raw material in stock	3.50
(ii) Word-in-process	1.00
(iii) Finished goods in stock	6.00
(iv) Debtors collection period	4.50
Operating Cycle	15.00

The creditors is payable within the operating cycles. Therefore, it is to be classified as '***current liabilities***'.

II. Assets

Just like liabilities, assets are also to be classified under two broad headings :

1. Non-current Assets; and 2. Current Assets

1. Non-current Assets

As per 'Schedule III' Non-current assets are sub- classified into ***five*** categories. These are :

(a) Fixed assets (with specified sub-classifications on the face of the Balance Sheet);
(b) Non-current investments;
(c) Deferred tax assets (Net);
(d) Long-term loans and advances;
(e) Other non-current assets.

(a) Fixed Assets

Fixed assets are sub-classified on the face of the Balance Sheet as follows :

(i) Tangible assets
(ii) Intangible assets
(iii) Capital work-in-progress (related to tangible assets)
(iv) Intangible assets under development

(i) ***Tangible assets*** : Tangible fixed assets are required to be further classified into ***seven*** categories : The details are to be shown in the '***Notes to Account***'. It will appear as follows :

(a) Land
(b) Buildings
(c) Plant and Equipment
(d) Furniture and Fixtures.
(e) Vehicles.
(f) Office equipment.
(g) Others (specify nature).

Assets under lease shall be separately specified under each class of asset.

A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the ***first five years*** subsequent to the date of such reduction or increase.

(ii) ***Intangible Assets*** : Recognising the importance of intangible assets, the 'Schedule III' requires them to be presented separately on the face of the Balance Sheet. The details are shown in the ***'Notes to Accounts'*** as follows :

(a) Goodwill.
(b) Brands /trademarks.

(c) Computer software.
(d) Mastheads and publishing titles.
(e) Mining rights.
(f) Copyrights, and patents and other intellectual property rights, services and operating rights.
(g) Recipes, formulae, models, designs and prototypes.
(h) Licenses and franchise.
(i) Others (specify nature).

A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

(iii) ***Capital Work-in-Progress*** : Capital work-in-progress is shown in the Schedule III as a separate item under fixed assets. The aggregate amounts to be disclosed relating to tangible fixed assets. It is to be noted that any advance for capital works will not be shown under this heading. It is to be shown under '***long-term loans and advances***'.

(iv) ***Intangible Assets under Development :*** Intangible assets under development is to be disclosed separately in the Schedule III. It is to be noted that the amount to be recognised and measured as per AS-26 : '***Intangible Assets***'.

(b) Non-current Investments

In the pre-revised Schedule VI, all investments used to be shown under a separate heading 'Investments'. However, in the Schedule III investments are to be classified into :

(a) Non-current investments and
(b) Current investments

Non-current investments are shown under *'Non-current Assets'* and current investments are shown under *'Current Assets'*.

In the '***Notes to Accounts'*** details of non-current investments are to be shown as follows :

(a) Investment property;
(b) Investments in Equity Instruments;
(c) Investments in preference shares
(d) Investments in Government or trust securities;
(e) Investments in debentures or bonds;
(f) Investments in Mutual Funds;
(g) Investments in partnership firms
(h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;
(b) Aggregate amount of unquoted investments;
(c) Aggregate provision for diminution in value of investments

It should be noted that, the definition of current investments and non-current investments as per **AS-13** :

'***Accounting for Investments***' is not similar as in the 'Schedule III'. AS- 13 defines 'current investments' as "***an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.***"

As per Schedule III

An asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is expected to be realized within twelve months after the reporting date; or
(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

Under Schedule III a current investment does not necessarily have to be '***readily realisable by nature***'. In this situation, all investments to be classified as per AS-13 :'***Accounting for Investments***' because the accounting standard will prevail over Schedule III as has been mentioned in 'General Insturctions' of Schedule III, Para No. 1

(c) Long-term Loans and Advances

Schedule III requires that 'long-term loans and advances' are to be shown separately on the face of the Balance Sheet under main heading '***Non-current Assets***'. The details are to be shown in the 'Notes to Accounts' as follows :

(a) Capital Advances;
(b) Security Deposits;
(c) Loans and advances to related parties (giving details thereof);
(d) Other loans and advances (specify nature).

The above shall also be separately sub-classified as:

(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(d) Other Non-current Assets

Other non-current assets shall be classified as:

(i) Long Term Trade Receivables (including trade receivables on deferred credit terms);
(ii) Others (specify nature)
(iii) Long term Trade Receivables, shall be sub-classified as:
    (i) (a) Secured, considered good;
        (b) Unsecured considered good;
        (c) Doubtful
    (ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
    (iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

2. Current Assets

As Per Schedule III, current assets are sub-classified into ***six*** categories. These are shown on the face of the Balance Sheet as follows :

(a) Current Investments
(b) Inventories
(c) Trade Receivables
(d) Cash and Cash Equivalents

(e) Short-term Loans and Advances
(f) Other Current Assets

(a) Current Investments

As per Schedule III 'current investments' are to be shown separately on the face of the Balance Sheet under '***Current Assets***.' The details of current investments are to be shown in the ***Notes to Accounts*** as follows:

(a) Investments in Equity Instruments;
(b) Investment in Preference Shares
(c) Investments in Government or trust securities;
(d) Investments in debentures or bonds;
(e) Investments in Mutual Funds;
(f) Investments in partnership firms
(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given. The following shall also be disclosed:

(a) The basis of valuation of individual investments
(b) Aggregate amount of quoted investments and market value thereof;
(c) Aggregate amount of unquoted investments;
(d) Aggregate provision made for diminution in value of investments.

(b) Inventories

As per Schedule III total of 'Inventories' is to be disclosed on the face of the Balance Sheet. However, the details are to be shown in the 'Notes to Accounts' as follows :

(a) Raw materials;
(b) Work-in-progress;
(c) Finished goods;
(d) Stock-in-trade (in respect of goods acquired for trading);
(e) Stores and spares;
(f) Loose tools;
(g) Others (specify nature).

Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

Mode of valuation shall be stated.

(c) Trade Receivables

Amount due from customers for sale of goods and services are to be shown under this heading on the face of the Balance Sheet. Amount due from different parties for sale of assets, sale of scraps, etc. should not be shown under this heading. In the 'Notes to Accounts' the details are to be shown as follows :

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are ***due for payment*** should be separately stated.
(ii) Trade receivables shall be sub-classified as:
   (a) Secured, considered good;
   (b) Unsecured considered good;
   (c) Doubtful.
(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Points to be Noted

1. ***Trade Receivables will include bills receivable accepted by the customers.***
2. ***Trade Receivables outstanding for more than 6 months is to be shown separately. However, this six months is to be calculated from the due date of the payment. Thus, this period of six months should be calculated after excluding the contractual credit period.***

(d) Cash and Cash Equivalents

As per Schedule III cash and cash equivalents are to be shown as separate line item under 'Current Assets'. The term 'cash equivalent' has been defined in AS-3 : Cash Flow Investment as "***cash equivalents are short-term, highly liquide investments that are readily convertible into known amount of cash and which is subject to an insignificant risk of changes in value***."

It is to be noted that cash equilvanets are held for the purpose of meeting short-term cash commitments rather than for investments or other purposes.

In the ***'Notes to Accounts;'*** it is to be shown as follows :

(i) Cash and cash equivalents shall be classified as:
   - (a) Balances with banks;
   - (b) Cheques, drafts on hand;
   - (c) Cash on hand;
   - (d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

(e) Short-term Loans and Advances

Short-term loans and advances are to be shown as a separate line item under 'Current Assets'. The details are to be shown in the 'Notes to Accounts' as follows :

(a) Loans and advances to related parties (giving details thereof);
(b) Others (specify nature).

The above shall also be sub-classified as:

(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

(f) Other Current Assets

It is a residuary heading which accomodates all current assets that do not fall in any category of 'Current Assets' specified above.

Some of the items which may be included in this heading are :

(i) unbilled revenue
(ii) accrued interest on investment
(iii) pre-paid expenses, etc.

Statement of Profit and Loss

In the pre-revised Schedule VI, there was no prescribed form for the preparation of Profit and Loss Account. However, Schedule III gives a 'form' for the preparation of Statement of Profit and Loss. It specifies the minimum line items to be presented on the face of the Statement of Profit and Loss.

The specimen of the form is given below :

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Company ....

Profit and Loss Statement for the year ended ....(₹ in ....)

Particulars	Note No.	Figures for the current reporting period	Figures for the previous reporting period
I. Revenue from operations		xxx	xxx
II. Other income		xxx	xxx
III. Total Revenue (I + II)		xxx	xxx
IV. Expenses:			
Cost of materials consumed		xxx	xxx
Purchases of Stock-in-Trade		xxx	xxx
Changes in inventories of finished goods work-in-progress and Stock-in-Trade		xxx	xxx
Employee benefits expense		xxx	xxx
Finance costs		xxx	xxx
Depreciation and amortization expense		xxx	xxx
Other expenses		xxx	xxx
Total expenses		xxx	xxx
V. Profit before exceptional and extraordinary items and tax (III–IV)		xxx	xxx
VI. Exceptional items		xxx	xxx
VII. Profit before extraordinary items and tax (V–VI)		xxx	xxx
VIII. Extraordinary Items		xxx	xxx
IX. Profit before tax (VII– VIII)		xxx	xxx
X. Tax expense:			
(1) Current tax		xxx	xxx
(2) Deferred tax		xxx	xxx
XI. Profit (Loss) for the period from continuing operations		xxx	xxx
XII. Profit/(loss) from discontinuing operations		xxx	xxx
XIII. Tax expense of discontinuing operations		xxx	xxx
XIV. Profit/(loss) from Discontinuing operations (after tax) (XII–XIII)		xxx	xxx
XV. Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI. Earnings per equity share:			
(1) Basic		xxx	xxx
(2) Diluted		xxx	xxx

See accompanying notes to the financial statements

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (ii) of Clause (40) of Section 2 of the Companies Act, 2013 in like manner as they apply to a statement of profit and loss.

2.(A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from
(a) sale of products;
(b) sale of services;
(c) other operating revenues;
Less:(d) Excise duty.

(B) In respect of a finance company, revenue from operations shall include revenue from
(a) Interest; and
(b) Other financial services

3. **Finance Costs**

Finance costs shall be classified as:
(a) Interest expense;
(b) Other borrowing costs;
(c) Applicable net gain/loss on foreign currency transactions and translation.

4. **Other Income**

Other income shall be classified as:
(a) Interest Income (in case of a company other than a finance company);
(b) Dividend Income;
(c) Net gain/loss on sale of investments
(d) Other non-operating income (net of expenses directly attributable to such income).

5. **Additional Information**

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

(i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].
(b) Depreciation and amortization expense;
(c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹.1,00,000, whichever is higher;
(d) Interest Income;
(e) Interest Expense;
(f) Dividend Income;
(g) Net gain/ loss on sale of investments;
(h) Adjustments to the carrying amount of investments;
(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
(j) Payments to the auditor as (a) auditor,(b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses;
(k) Details of items of exceptional and extraordinary nature;
(l) Prior period items;

(ii) (a) In the case of manufacturing companies,-
(1) Raw materials under broad heads.
(2) Goods purchased under broad heads.
(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.
(c) In the case of companies rendering or supplying services, gross income derived form services rendered or supplied under broad heads.
(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.
(e) In the case of other companies, gross income derived under broad heads.

(iii) In the case of all concerns having works in progress, works-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.
(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.
(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(vi) Expenditure incurred on each of the following items, separately for each item:-

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(g) Insurance .

(h) Rates and taxes, excluding, taxes on income.

(i) Miscellaneous expenses,

(vii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(viii) The profit and loss account shall also contain by way of a note the following information, namely:-

(a)Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

I.Raw materials;

II.Components and spare parts;

III.Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:-

I.Export of goods calculated on F.O.B. basis;

II.Royalty, know-how, professional and consultation fees;

III.Interest and dividend;

IV.Other income, indicating the nature thereof.

Note:-Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements".

Points to be Noted

1. ***The details of the items shown on the face of the Statement of Profit and Loss is to be disclosed in the Notes to Account as per 'General Instructions for Preparation of Statement of Profit or Loss'.***
2. ***An item of income or expense should be separately disclosed if it exceeds 1% of the revenue from operation or ₹ 1,00,000 whichever is higher.***
3. ***Revenue from operations of non-finance company is required to be disclosed in the Notes to Accounts as follows :***

(a) Sale of Products	*****
(b) Sale of Services	*****
(c) Other Operating Revenues	*****
	*****
Less: Excise Duty	*****
	*****

4. ***VAT should not be included in the 'revenue' as it is collected on behalf of VAT authorities and it is paid within a certain period to VAT authorities. Similarly sales tax, service tax should not be included in 'revenue'.***
5. ***Exceptional items should be disclosed separately on the face of the Statement of Profit and Loss. The details should be disclosed in the Notes to Accounts if there is more than one item.***
6. ***Extra-ordinary items are to be disclosed separately on the face of the Statement of Profit and Loss. The details should be disclosed in the Notes to Accounts if there is more than one item.***

Meaning of Exceptional Items

Schedule III requires that the exceptional items to be disclosed separately on the face of the Statement of Profit and Loss. It is to be deducted for arriving at '***profit before extra- ordinary items and tax***.' However, the exceptional item has not been defined in the Schedule III or in any accounting standard.

In this respect it is to be noted that Accounting Standard Board (ASB) in 1999 had defined this term as follows :

"***Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individual or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give true or fair view***."

Here main points are :

(i) Exceptional items falls within the ordinary activities (i.e., normal business activities of the entity).
(ii) It must be material.

Examples of exceptional items are :

(i) Profits or losses on the sale or termination of an operation.
(ii) Cost of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations.
(iii) Profits or losses on disposal of fixed assets.

In all the above cases, the amount of profits or losses must be material.

Meaning of Ordinary Activities

Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of incidental to, or arising from, these activities.

Meaning of Extraordinary Items

Schedule III requires that extraordinary items are to be disclosed on the face of the Statement of Profit and Loss. It is to be deducted for arriving at '***profit before tax***'.

Extraordinary items are those items which arise from abnormal or unusual events lying outside the ordinary range of entity's activities and which are both ***material and expected not to occur frequently or regularly***.

Classification of an item as extraordinary will depend on the circumstances of a business. An event or transaction may be extraordinary for one entity but not so for another entity. This is because of the differences between their respective ordinary activities. ***For example***, losses sustained as a result of an earthquake may qualify as an extraordinary item for many entities. However, claims for an insurance company that insures against such risks is an ordinary item.

It should be remembered that only on rare occasions do an event or transaction give rise to an extraordinary item.

Typical Adjustments related to Company Final Accounts

1. Depreciation

Before the amendment of the Companies Act, 1956 in 1988, depreciation was required to be provided at the rate specified for the various assets by the Income Tax Act. Due to sharp increase in the depreication rates under the Income Tax Act, it was felt that the companies will find it difficult to pay dividend owing to lack of profit after depreciation and an amendment was proposed. After the amendment in 1988, depreciation used to be calculated in accordance with the rates specified in the Schedule XIV to the Companies Act, 1956.

However, after the introduction of the Companies Act, 2013 the depreciation shall be calculated as per the provision of ***Schedule II of the Companies Act, 2013***. Some of the main points are as follows :

1. The depreciation shall be calculated on the basis of useful life and residual value as has been given in the Part 'C' of the Schedule II. ***For example***, Building (other than factory building), RCC Frame Structure's useful life is 60 years. If the depreciable amount (cost-residual value) is ₹ 24,00,000. The depreciation will be ₹ 40,000 per annum (24,00,000 ÷ 60).

For understanding the concept, a small portion of ***'Part-C' of Schedule II*** is given below :

Nature of Assets	Useful Life [Years]
I. Buildings (NESD)*	
(a) Buildings (other than factory building) RCC Frame Structure	60
(b) Buildings (other than factory buildings) other than RCC Frame Structure	30
(c) Factory buildings	30
(d) Fences, wells, tube wells	5
(e) Others (including temporary structure, etc.)	3
II. Bridges, culverts, bunders, etc. [NESD]*	30
III. Roads [NESD]*	
(a) Carpeted roads	
(i) Carpeted Roads – RCC	10
(ii) Carpeted Roads – other than RCC	5

* 'NESD' stands for 'No Extra Shift Depreciation'

2. During the financial year, if any addition has been made or any asset has been sold, discarded or destroyed, the depreciation on such assets shall be calculated on a ***pro-rata basis*** from the date of such addition or as the case may be, upto the date on which such assets have been sold, discarded, demolished or destroyed.
3. Depreciable amount is the cost of an asset or other current substitudes for cost, less its residual value. Ordinarily, the residual value of an asset is often insignificant but it should generally be not more than 5% of of the original cost of the asset.
   For example, original cost of the Plant = ₹ 10,00,000. The residual value should not be more than ₹ 50,000 (5% of ₹ 10,00,000). The depreciable amount will be ₹ 10,00,000 – ₹ 50,000 = ₹ 9,50,000. The depreciation will be ₹ 9,50,000 ÷ useful life as per Schedule II applicable for that particular asset.
4. Useful life specified in Part C of the Schedule II is for whole of the asset where cost of the part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.
   For example, in case of a passenger plane, the useful life of its engine, instrument panel, body, landing gear may be different according to situation.
5. For the purpose of this Schedule, the term 'depreciation' includes amortisation.
6. The useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under the Act of Parliament or by the Central Government shall be applicable in calculating the depreciation to be provided for such asset irrespective of the requirements of the Schedule.
7. Without prejudice to the foregoing provisions :
   (i) In case of such class of companies, as may be prescribed and whose financial statements comply with the accounting standards prescribed for such class of companies under section 133, the useful life of an asset shall not normally be different from the useful life and the residual value shall not be different from that as indicated in Part C, provided that if such a company uses a useful life or residual value which is different from the useful life or residual value indicated therein, it shall disclose the justification for the same.
   (ii) In respect of other companies the useful life of an asset shall not be longer than the useful life and the residual value shall not be higher than that prescribed in Part C.
   (iii) For intangible assets, the provisions of the Accounting Standards mentioned under sub-para (i) or (ii), as applicable, shall apply.
8. If an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

It is to be noted that (as per the provision of Section 123 of the Companies Act, 2013), dividend may be declared out of profits of the company for the current year after providing for depreciation as per Schedule II.

Section 198 also provides that the net profits for the calculation of managerial remuneration shall be determined only after providing for depreciation as per Schedule II.

The Companies Act 2013, provides that the original cost, the accumulated depreciation to date and the written-down value of each assets should be shown in the 'Notes to Accounts'. To fulfill the requirements of the Companies Act, depreciation is recorded in the books of the company by passing the following entry :

Depreciation Account Dr.
To Provision for Depreciation/Accumulated Depreciation Account
(Being the depreciation for the year provided for)

Depreciation is shown on the face of the Statement of Profit and Loss as a line item under '***Expenses'.***

Accumulated depreciation upto the date of closing is shown in the 'Notes to Accounts' as a deduction from the original cost of the asset.

Illustration 3

Indus Ltd. imported machine having list price of ₹ 20,00,000, subject to 5% trade discount. 3% import duty was paid and 3% of refundable tax was also paid.

It was to be installed in workplace where a machine already existed. The cost of dismantling and removing old machine amounted to ₹ 43,000.

The following costs were also incurred :

(i) Site preparation cost ₹ 60,000.
(ii) Construction of machine room ₹ 2,00,000.
(iii) The engineer was paid ₹ 40,000 for testing and operation.
(iv) Transporting and loading plus unloading cost ₹ 3,00,000.

You are required to calculate the total cost of machine for the purpose of depreciation calculation.

Solution **Statement Showing the Total Cost of the Machine**

Particularss		₹]
List Price		20,00,000
Less: 5% Discount		1,00,000
		19,00,000
Add: (i) 3% Import Duty (3% of ₹ 19,00,000)	57,000	
(ii) Cost of Dismantling and Removing of old machine	43,000	1,00,000
		20,00,000
Additional Cost :		
(i) Site Preparation	60,000	
(ii) Cosntruction of Machine Room	2,00,000	
(iii) Engineer's fees	40,000	
(iv) Transportation on loading and unloading	3,00,000	6,00,000
Total Cost of the Machine		26,00,000

Tutorial Notes :

(1) Refundable tax should not be included in the cost of the machine.
(2) Dismantling expenses are incidental to new machine. Therefore, it should be included in the cost of the machine.

Illustration 4

On 1st April, 2016, the details of Non-current assets of Hero Ltd were as follows :

Assets	Cost (₹)	Accumulated Depreciation (₹)
Land	1,00,00,000	Nil
Building	40,00,000	3,60,000
Equipments	79,04,500	21,04,500
Motor Vehicles	6,42,250	2,84,770
Total	2,25,46,750	27,49,270

The company's depreciation policy is :

1. A full year's depreciation is charged on all assets acquired during the year. No depreciation is charged for assets sold during the year.
2. The rate of depreciation will be :
   (a) Land — Nil
   (b) Building @ 2% p.a. on straight line basis.
   (c) Equipment @ 20% p.a. on straight line basis.
   (d) Motor Vehicles @ 25% p.a. reduing balance basis.

During the year ending on 31st March, 2017, the following transactions relating to non-current assets took place :

(i) The directors decided to re-value the land and an independent valuation report stated that the value of land should be ₹ 1,20,00,000 on 31st March, 2017.

(ii) A motor vehicle was sold for ₹ 20,500. Its original cost was ₹ 64,000. The accumulated depreciation on 1st April, 2016 was ₹ 37,000.

(iii) Equipment was bought for ₹ 5,14,000.

Required :

(i) Calculate the total charge to Statement of Profit and Loss for the year ended on 31st March, 2017 in respect of non-current assets;

(ii) Calculate the value of non-current assets showing gross block, depreciation and net block which should be represented in the Balance Sheet as at 31st March, 2017.

Solution

(i) Calculation of Depreciation

			₹
(a) Building			
Cost ₹ 40,00,000 × 2%			80,000
(b) Equipment			
Cost b/f		79,04,500	
Purchased		5,14,000	
Total Cost		84,18,500 × 20%	16,83,700
(c) Motor Value			
Cost b/f		6,42,250	
Sold		64,000	
		5,78,250	
Less: Accumulated Depreciation :			
B/f	2,84,770		
Sold	37,000	2,47,770	
		3,30,480 × 25%	82,620
Total Depreciation for the year			18,46,320

(ii) Loss on Sale of Motor Vehicle

Original cost	64,000	
Less: Accumulated depreciation	37,000	
Written-down value	27,000	
Less: Sales Proceeds	20,500	6,500

Total amount to be charged to Statement of Profit and loss = ₹ 18,46,320 + 6,500 = ₹ **18,52,820**.

(b) Calculation of Value of Non-Current Assets on 31st March, 2017 (₹)

Tangible Assets	Gross Block				Depreciation				Net Block
	As at 1.4.2016	Additions	Deduction	As at 31.3.2017	As at 1.4.2017	For the year	Adjustment	Upto 31.3.2017	As at 31.3.2017
Land	1,00,00,000	20,00,000	—	1,20,00,000	—	—	—	—	1,20,00,000
Buildings	40,00,000	—	—	40,00,000	3,60,000	80,000	—	4,40,000	35,60,000
Equipments	79,04,500	5,14,000	—	84,18,500	21,04,500	16,83,700	—	37,88,200	46,30,300
Motor Vehicles	6,42,250	—	64,000	5,78,250	2,84,770	82,620	37,000	3,30,390	2,47,860
Total	2,25,46,750	25,12,000	64,000	2,49,96,750	27,49,270	18,46,320	37,000	45,58,590	2,04,38,160

Illustration 5

In the accounting period ending on 31st March, 2014, Eastern Tour and Travel Ltd purchased a new office at Delhi. The cost of the new office were :

		₹
(i)	Land (on which the building is situated)	60,00,000
(ii)	Building 1,10,00,000	
(iii)	Site preparation	5,00,000
(iv)	Maintenance Charges for the year to 31st July, 2017	60,000

At 31st March, 2015 the market value of the office had increased by ₹ 20,00,000. This increase in the value was recognised in the financial statement for that year.

After depreciation charges for the two years to 31st March, 2017, the carrying value of the office at that date was ₹ 1,80,48,000. During the year to 31st March, 2017 the value of the property fell by ₹ 20,00,000 to ₹ 1,60,48,000.

Requirements :

(1) What is the original value at which that office was recorded in the year to 31st March, 2014 ?

(2) What amount will be charged in the Statement of Profit and Loss for the year to 31st March, 2017 in respect of reduction in the value of the property ?

Solution

(1) Service charges of ₹ 60,000 should not be capitalised. The proportionate amount will be charged to Statement of Profit and Loss, The office was recorded after adding the following expenses :

(a) Land on which building is situated	60,00,000
(b) Building	1,10,00,000
(c) Site preparation	5,00,000
Total	1,75,00,000

(2) At 31st March, 2015 the market value of the new office was increased by ₹ 20,00,000. This was recognised by passing the following Journal entry :

New Office Account	Dr.	20,00,000	
To Revaluation Reserve Account			20,00,000

At 31st March, 2017, after charging depreciation for two yea rs the carrying value of new building was ₹ 1,80,48,000. However, the value of the new office fell down to ₹ 1,60,48,000. Net fall of ₹ 20,00,000 should be adjusted against the **Revaluation Reserve** of ₹ 20,00,000. Therefore, **nothing is to be debited to Statement of Profit and Loss**.

2. Interest on Debentures

A company may raise fund by floating debentures in the market. A fixed rate of interest is paid on such debentures and it is usually paid half yearly. At the time of preparation of Company Final Accounts, calculate the total interest ***payable*** on debentures for the accounting year and the amount actually ***paid*** for the year.

The difference between the two figures represents outstanding interest.

Outstanding interest on debentures is to be shown in the 'Notes to Accounts' under ***Other Current Liabilities***. It is to be noted that both 'interest accrued but not due' and 'interest accrued and due' will be shown under the same heading, i.e., Other Current Liabilities.

3. Tax Deducted at Source

As per the provisions of Section 193 and 194 of the Income Tax Act, 1961, it is the duty of the payer of salary, interest, dividends etc. to deduct tax at the prescribed rate, and to deposit the tax so deducted to the credit of the Central Government within a specified time. The payment may be made at any office of the RBI or SBI or its subsidiaries conducting government business.

When tax is deducted by the company as per the provision of the Income Tax Act, the following entry is passed:

Salaries/Dividends/Interest Account Dr
To Bank Account
To Tax Deducted at Source Account

At the time of payment to the Government, the following entry is passed:

Tax Deducted at Source Account Dr
To Bank Account

At the end of the year, if there is any balance in the "Tax Deducted at Source Account", it is shown in the credit side of the Trial Balance. In the Balance Sheet it is shown as a current liability.

4. Advance Payment of Income Tax

A company is liable to pay tax on its income. Income-tax is payable in the "Assessment year" in respect of the income of the "Previous year". ("Assessment year" means a period of 12 months starting from 1st April and ending on 31st March next. "Previous year" is the financial year immediately preceding the assessment year. **Example:** If the Assessment year is 2016-17, the Previous year will be 2015-16).

Though the income of the previous year will be assessed in the assessment year, an assessee has to pay tax in advance in the previous year itself for his probable liability to tax in the assessment year immediately following. This advance payment of tax is also known as 'pay as you earn'. Advance tax shall be payable during a previous year when the amount of such tax payable during that year is ₹ 10,000 or more.

The amount of advance tax is computed in accordance with the provisions of Sections 208 to 219 of the Income Tax Act, 1961. When advance tax is paid, the following entry is passed:

Advance Income Tax Account Dr.
To Bank Account
(Being advance income tax paid for the previous year ...)

In the Balance Sheet it is shown under the heading '***Short-term Loans and Advances***' under '***Current Assets'***.

5. Provision for Taxation

Since a company is a separate legal entity, it is liable to tax at flat rate on its annual profit. Income tax payable by a company is deducted from 'Profit before Tax' to ascertain 'Profit after Tax'. The taxable income is determined on the basis of self-assessment. After determining the tax liability, the company makes a provision for it in the Final Accounts.

In the Balance Sheet, it is shown under main head '***Current Liabilities'*** and under sub-head '***Short-term Provision***' on the face of the Balance Sheet.

When assessment is completed, the 'Provision for Income Tax' is adjusted. If the assessed tax amount is more than the provision made in the previous year, the excess has to be shown as deducted from ***carried forward balance of Profit and Loss***. All details are shown in the 'Notes to Accounts' under main heading '***Resserve and Surplus***'.

If the assessed tax amount is less than the provision made in the previous year, the excess is added with ***carried forward balance of Profit and Loss***.

Illustration 6

The trial balance of P Ltd. as at 31st March, 2017 shows the following items :

Trial Balance of P Ltd. as at 31st March, 2017

S.No.	Name of Account	₹	₹
	Advance Income Tax — 2015-16	1,10,000	
	Advance Income Tax — 2016-17	1,15,000	
	Provision for Income Tax — 2015-16		1,00,000

Additional information :

(1) The income tax assessment for 2015-16 completed during the year showed gross tax demand of ₹ 1,20,000 but no effect has been given for this in the account.

(2) Provision for income tax is to be made for ₹ 1,05,000 for 2016-17.

You are required to show :

(a) Relevant journal entries; and

(b) Relevant extract of the Balance Sheet.

Solution

Provision for income tax for the year 2015-16 was ₹ 1,00,000 but the assessed tax liability is ₹ 1,20,000. Therefore, ₹ 20,000 is to be deducted from the carried forward balance of Profit and Loss of 2015-16. The assessed tax for 2015-16 is ₹ 1,20,000 but the advance tax paid was ₹ 1,10,000. The adjusting entries are to be passed for this.

The provision for income tax for the year 2016-17 of ₹ 1,05,000 is to be provided by passing the following journal entry :

In the books of P Ltd.
Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2017 March 31	Statement of Profit and Loss Dr. To Provision for Income TAx (2016-17) A/c (Being the creation of the provision for income tax for the year 2016-17)		1,05,000	 1,05,000
	Provision for Income Tax A/c Dr. Reserve and Surplus A/c / Statement of Profit and Loss (2015-16) Dr. To Advance Income Tax (2015-16) A/c. To Liability for Taxation A/c (Being the adjustment of advance tax of 2015-16 with tax liability of 2015-16)		1,00,000 20,000	 1,10,000 10,000

Balance Sheet of P Ltd. as at 31st March, 2017 [Extract]

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus		?
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		?
(3) Non-current Liabilities :		?
(4) Current Liabilities :		
(a) Liability for Income Tax of 2015-16		10,000
(b) Short-term Provisions (Provision for Income Tax — 2016-17)		1,05,000
TOTAL		
II. ASSETS		
(1) Non-current Assets :		
(2) Current Assets :		
(a) Short-term Loans and Advances (Advance Tax for 2016-17)		1,15,000
TOTAL		

Illustration 7

The Trial Balance of Complex Ltd. as at 31st March, 2017 shows the following items :

Particulars	Dr (₹)	Cr (₹)
Advance payment of Income tax	2,20,000	
Provision for Income tax for the year ended 31.3.2016		1,20,000

The following further information is given :

(i) Advance payment of income tax includes ₹ 1,40,000 for 2015-16.

(ii) Actual tax liability for 2015-16 amounts to ₹ 1,52,000 and no effect for the same has so far been given in accounts.

(iii) Provision for income tax has to be made for 2016-17 for ₹ 1,60,000.

You are required to prepare :

(a) Provision for Income Tax Account;

(b) Advance Payment of Income Tax Account;

(c) Liabilities for Taxation Account and also show, how the relevant items will appear in the Balance Sheet of the Company.

Solution

In the books of Complex Ltd

Dr. **Provision for Income Tax (2015-16) Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.3.2017	To Advance Payment of Income Tax A/c	1,40,000	1.4.2016	By Balance b/d	1,20,000
31.3.2017	To Liability for Taxation A/c	12,000	31.3.2017	By Satement of Profit and Loss (2015-16) / Reserve and Surplus A/c	32,000
		1,52,000			1,52,000

Dr. **Provision for Income Tax (2016-17) Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.3.2017	To Balance c/d	1,60,000	31.3.2017	By Statement of Profit and Loss (2016-17)	1,60,000

Dr. **Advance Payment of Income Tax Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2016	To Balance b/d	2,20,000	31.3.2017	By Prov. for Income Tax (2015-16) A/c	1,40,000
			31.3.2017	By Balance c/d	80,000
		2,20,000			2,20,000

Dr. **Liability for Taxation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.3.2017	To Balance c/d	12,000	31.3.2017	By Provision for Income Tax A/c	12,000

Balance Sheet of Complex Ltd. as at 31st March, 2017 [Extract]

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		?
(b) Reserves and Surplus		?
(c) Money Received against Share Warrants		?
(2) Share Application Money Pending Allotment :		?
(3) Non-current Liabilities :		?
(4) Current Liabilities :		
(a) Liability for Income Tax of 2015-16		12,000
(b) Short-term Provisions (Provision for Income Tax — 2016-17)		1,60,000
TOTAL		
II. ASSETS		
(1) Non-current Assets :		
(2) Current Assets :		
(a) Short-term Loans and Advances (Advance Income Tax)		80,000
TOTAL		

6. Dividend

A dividend may be defined as a distribution of *divisible profit* of a company among the shareholders according to the number of shares held by each of them in the capital of the company.

The Board of Directors recommend the amount of profit which is to be distributed as a dividend. The shareholders in the annual general meeting may declare the dividend, recommended by the board of directors. However, the shareholders may declare a dividend smaller than recommended by the board, but no dividend shall exceed the amount recommended by the board.

Proposed Dividend The dividend recommended by the board of directors is termed as ***proposed dividend***. In the Balance Sheet, it is shown as '***Short-term Provision***'. When the proposed dividend is adopted in the Annual General Meeting by the shareholders, it is termed as "***declared dividend***". It should be noted that declared dividend must be paid within 30 days of declaration. Unpaid / unclaimed dividend is shown as '***Other Current Liabilities***'.

Interim Dividend The dividend declared by the Board of Director before the preparation of Final Accounts is termed as ***interim dividend***. Where the articles authorise, the directors can resolve to pay interim dividend. As per the provision of Clause 86 of Table A of Schedule I to the Companies Act, the board of directors may from time to time pay to the members such interim dividend as appear to it to be justified by the profits of the company. The interim dividend is paid during the year and it will appear in the Trial Balance.

When ***interim dividend is paid***, the following entry is passed:

Interim Dividend Account Dr.
    To Bank Account

The interim dividend is deducted from the profit of the current year as appropriation in the 'Notes to Accounts'.

Final Dividend The directors after declaring interim dividend, may declare another dividend. This dividend is termed as ***final dividend***. The interim dividend is not adjusted when final dividend is declared unless the resolution mentions it specifically.

Dividend on Preference Shares The preference shareholders are entitled to receive a dividend at a fixed rate. If the directors decides to declare a dividend on equity shares, it is compulsory to make a provision first for the payment of one year's dividend to preference shareholders.

To record the preference dividend, the following entry is passed:

Profit and Loss (Appropriation) Account Dr.
  To Preference Dividend Account

Unpaid and Unclaimed Dividends

As per the provision of Section 124 of the Companies Act, 2013 :

(1) Where a dividend has been declared by a company but has not been paid or claimed within thirty days from the date of the declaration to any shareholder entitled to the payment of the dividend, the company shall, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account.

(2) The company shall, within a period of ninety days of making any transfer of an amount under sub-section (1) to the Unpaid Dividend Account, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

(3) If any default is made in transferring the total amount referred to in sub-section (1) or any part thereof to the Unpaid Dividend Account of the company, it shall pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of twelve per cent. per annum and the interest accruing on such amount shall enure to the benefit of the members of the company in proportion to the amount remaining unpaid to them.

7. Corporate Dividend Tax (CDT)

As per the provision of Section 115 O to 115 Q, Corporate Dividend Tax is payable in addition to the income tax payable by the company. It is applicable to a domestic company only.

The following points are important in this respect :

(i) Corporate Dividend Tax is payable on any amount declared, distributed or paid by the company as dividend (interim or otherwise). The dividend may be paid out of current profit or accumulated profit.

(ii) No credit shall be claimed by the company or by any person in respect of tax so paid.

(iii) Corporate Dividend Tax is to be paid even if no income tax is payable by that company.

(iv) Corporate Dividend Tax can not be adjusted against brought forward tax credit under MAT (Section 115 JJA).

Accounting for Corporate Dividend Tax

The liability for CDT will be recognised in the same accounting year in which the dividend has been recognised.

In the Balance Sheet CDT will be shown as a liability under 'Current Liabilities and Provisions'.

Rate of Corporate Dividend Tax

Before the amendment in Section 115 of the Finance Act, 2014, the 'Dividend Distribution Tax' used to be paid @ 15% on the net amount. ***For example***, if the dividend paid was ₹ 100, the dividend distribution tax was ₹ 15 (15% of ₹ 100). However, after the amendment in the Finance Act, 2014, the dividend would be required to be grossed up for the purpose of calculation of the effective rate of dividend distribution tax. The basic rate will be :

$$\left(\frac{100}{85}\right) \times 15\% = 17.647$$

The final rate will be:

Basic Rate	17.647%
Add: Surcharge @ 12%	2.118%
	19.765%
Add: Education Cess @ 2% of 19.765%	0.395%
Add: Higher Education Cess @ 1% of 19.765%	0.198%
	20.358%

8. Suspense Accounts

Sometimes, an item cannot be posted to the correct account for one reason or another and it is shown in the Suspense Account. At the time of preparation of Final Accounts, it is to be adjusted.

(i) Capital Suspense Account It may so happen that the entry on forfeiture has been passed but money received on re-issue has been credited to Capital Suspense Account. For adjustment, the following entry will be passed:

Capital Suspense Account Dr. [Money received]
Forfeited Share Account Dr. [Discount on re-issue]
To Share Capital Account

(ii) Sale proceeds of furniture may have been credited to Suspense Account and no entry made in the book for sale of furniture. For adjustment, the following entry will be passed:

Suspense Account Dr.
To Furniture Account

9. Calls-in-Arrear

At the time of issue of shares, any money not received in respect of allotment, first call or final call is transferred to Calls- in-Arrear Account. The entry will be:

Calls-in-Arrear Account Dr.
To Share Allotment Account
To Share 1st Call Account
To Share Final Call Account
(Being the amount not received transferred to Calls-in-Arrear Account)

In the Trial Balance, it will appear on the debit side. In the Balance Sheet it is shown by way of deduction from ***called-up capital***.

10. Forfeited Share Account

For non-payment of allotment money or call money or both, a company may forfeit shares by giving proper notice to the shareholders. When shares are forfeited, the following entry is passed:

Share Capital Account Dr. [Called-up value]
To Calls-in-Arrear Account [Money due]
To Forfeited Share Account [Money received]

In the Trial Balance Forfeited Shares Account will appear on the credit side. In the Balance Sheet it is shown as an addition with the paid-up share capital.

Managerial Remuneration

Overall Maximum Managerial Remuneration

As per the provision of Section 197(1) of the Companies Act, 2013, the total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year ***shall not exceed eleven per cent*** of the net profits of that company for that financial year computed in the manner laid down in section 198 except that the remuneration of the directors shall not be deducted from the gross profits:

Provided that the company in general meeting may, with the approval of the Central Government, authorise the payment of remuneration exceeding eleven per cent. of the net profits of the company, subject to the provisions of Schedule V:

Provided further that, except with the approval of the company in general meeting,—

(i) the remuneration payable to any one managing director; or whole-time director or manager ***shall not exceed five per cent*** of the net profits of the company and if there is more than one such director remuneration ***shall not exceed ten per cent*** of the net profits to all such directors and manager taken together;

(ii) the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed,—

(A) one per cent. of the net profits of the company, if there is a managing or whole-time director or manager;

(B) three per cent. of the net profits in any other case.

The percentages aforesaid shall be exclusive of any fees payable to directors.

Summary of Different Limits Based on Net Profit of the Company

Sl.No.	Managerial Personnel	% of Profit (Maximum)
1.	Directors including managing director and whole-time director, and its manager	11%
2.	If there is one managerial personnel, i.e., managing director or whole-time director or manager	5%
3.	If there are more than one managerial personnel, i.e., managing director and whole-time director or whole-time director and manager	10%
4.	Remumneration payable to directors who are neither managing director or whole-time director : (a) If there is a managing director or whole-time director or manager (b) In other cases	 1% 3%

Meaning of Remuneration

As per the provisions of Section 2(78) of the Companies Act, 2013, "remuneration means any money or its equivalent given or passed to any person for services rendered by him and includes ***perquisites*** as defined under the Income-tax Act, 1961."

It is important to note that the 'remuneration' shall also include ***reimbursement of any direct taxes*** to the managerial personnel.

Some of the examples of perquisites are given below :

(a) any expenditure incurred by the company in providing any rent-free accommodation, or any other benefit or amenity in respect of accommodation free of charge, to any of the persons specified in Sub-section (1) of Section 197 of the Companies Act, 2013.

(b) any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate to any of the persons aforesaid;

(c) any expenditure incurred by the company in respect of any obligation or service, which but for such expenditure by the company would have been incurred by any of the aforesaid persons; and

(d) any expenditure incurred by the company to effect any insurance on the life of or to provide any pension annuity or gratuity for, any of the aforesaid persons or his spouse or child.

Remuneration Payable by Companies having 'No Profit' or 'Inadequate Profit'

As per the provision of Section 197(3) of the Companies Act, 2013 if, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or wholetime director or manager, by way of remuneration any sum exclusive of any fees payable to directors under sub-section (5) hereunder except in accordance with the provisions of Schedule V and if it is not able to comply with such provisions, with the previous approval of the Central Government.

Schedule - V
PART II
REMUNERATION

Section I.— Remuneration payable by companies having profits:

Subject to the provisions of section 197, a company having profits in a financial year may pay remuneration to a managerial person or persons not exceeding the limits specified in such section.

Section II.— Remuneration payable by companies having no profit or inadequate profit without Central Government approval:

Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits under (A) and (B) given below:—

(A)

Sl.No.	Where the effective capital is	Limit of yearly remuneration payable shall not exceed (₹)
(i)	Negative or less than 5 crores	30 lakhs
(ii)	5 crores and above but less than 100 crores	42 lakhs
(iii)	100 crores and above but less than 250 crores	60 lakhs
(iv)	250 crores and above	60 lakhs plus 0.01% of the effective capital in excess of ₹ 250 crores

Provided that the above limits shall be doubled if the resolution passed by the shareholders is a special resolution.

Explanation.—It is hereby clarified that for a period less than one year, the limits shall be pro-rated.

(B) In the case of a managerial person who was not a security holder holding securities of the company of nominal value of rupees five lakh or more or an employee or a director of the company or not related to any director or promoter at any time during the two years prior to his appointment as a managerial person, — 2.5% of the current relevant profit:

Provided that if the resolution passed by the shareholders is a special resolution, this limit shall be doubled:

Provided further that the limits specified under this section shall apply, if—

(i) payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under sub-section (1) of section 178 also by the Nomination and Remuneration Committee;

(ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person;

(iii) a special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding three years;

(iv) a statement along with a notice calling the general meeting referred to in clause (iii) is given to the shareholders containing the relevant information.

Section III.— Remuneration payable by companies having no profit or inadequate profit without Central Government approval in certain special circumstances:

In the following circumstances a company may, without the Central Government approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:—

(a) where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under section 197.

(b) where the company—

  (i) is a newly incorporated company, for a period of seven years from the date of its incorporation, or

  (ii) is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction or National Company Law Tribunal, for a period of five years from the date of sanction of scheme of revival, it may pay remuneration up to two times the amount permissible under Section II.

(c) where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal:

Provided that the limits under this Section shall be applicable subject to meeting all the conditions specified under Section II and the following additional conditions:—

(i) except as provided in para (a) of this Section, the managerial person is not receiving remuneration from any other company;

(ii) the auditor or Company Secretary of the company or where the company has not appointed a Secretary, a Secretary in whole-time practice, certifies that all secured creditors and term lenders have stated in writing that they have no objection for the appointment of the managerial person as well as the quantum of remuneration and such certificate is filed along with the return as prescribed under sub-section (4) of section 196.

(iii) the auditor or Company Secretary or where the company has not appointed a secretary, a secretary in whole-time practice certifies that there is no default on payments to any creditors, and all dues to deposit holders are being settled on time.

(d) a company in a Special Economic Zone as notified by Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India, and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in any financial year, may pay remuneration up to ₹. 2,40,00,000 per annum.

Section IV.— Perquisites not included in managerial remuneration:

1. A managerial person shall be eligible for the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II and Section III:—
   (a) contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income-tax Act, 1961 (43 of 1961);
   (b) gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and
   (c) encashment of leave at the end of the tenure.
2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II or Section III—

   (a) ***Children's education allowance***: In case of children studying in or outside India, an allowance limited to a maximum of ₹. 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.
   (b) ***Holiday passage for children studying outside India or family staying abroad:*** Return holiday passage once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay abroad to India if they are not residing in India, with the managerial person.
   (c) ***Leave travel concession***: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

Explanation I.— For the purposes of Section II of this Part, ''effective capital'' means the aggregate of the paid-up share capital (excluding share application money or advances against shares); amount, if any, for the time being standing to the credit of share premium account; reserves and surplus (excluding revaluation reserve); long-term loans and deposits repayable after one year (excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short-term arrangements) as reduced by the aggregate of any investments (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities), accumulated losses and preliminary expenses not written off.

Explanation II.—

(a) Where the appointment of the managerial person is made in the year in which company has been incorporated, the effective capital shall be calculated as on the date of such appointment;

(b) In any other case the effective capital shall be calculated as on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.

Explanation III.— For the purposes of this Schedule, ''family'' means the spouse, dependent children and dependent parents of the managerial person.

Explanation IV.— The Nomination and Remuneration Committee while approving the remuneration under Section II or Section III, shall—

(a) take into account, financial position of the company, trend in the industry, appointee's qualification, experience, past performance, past remuneration, etc.;

(b) be in a position to bring about objectivity in determining the remuneration package while striking a balance between the interest of the company and the shareholders.

Explanation V.— For the purposes of this Schedule, ''negative effective capital'' means the effective capital which is calculated in accordance with the provisions contained in Explanation I of this Part is less than zero.

Explanation VI.— For the purposes of this Schedule:—

(A) ''current relevant profit'' means the profit as calculated under section 198 but without deducting the excess of expenditure over income referred to in sub-section 4 (l) thereof in respect of those years during which the managerial person was not an employee, director or shareholder of the company or its holding or subsidiary companies.

(B) ''Remuneration'' means remuneration as defined in clause (78) of section 2 and includes reimbursement of any direct taxes to the managerial person.

Section V. —Remuneration payable to a managerial person in two companies:

Subject to the provisions of sections I to IV, a managerial person shall draw remuneration from one or both companies, provided that the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from any one of the companies of which he is a managerial person.

Calculation of Net Profit for Managerial Remuneration

Managerial remuneration payable to its directors, including managing director and whole-time director and its manager is based on net profit which is calculated as per the provision of **Section 198** of the Companies Act, 2013. This net profit slightly differs from the normal profit as disclosed by the published Statement of Profit and Loss.

Net profit for this purpose is calculated after making the following ***four adjustments***:

1. ***Credit shall be given for the following sums*** (Section 198(2):
   Bounties and subsidies received from any Government or any public authority constituted or authorised in this behalf by any Government, unless and except in so far as the Central Government otherwise directs.

> ***Explantion : Bounties and subsidies received from any government or any public authority should be added with the gross profit.***

2. ***Credit shall not be given for the following sums*** (Section 198(3)***:***
   (a) profits, by way of premium, on shares or debentures of the company, which are issued or sold by the company;
   (b) profits on sales by the company of forfeited shares;
   (c) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;
   (d) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets:

Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value.

> ***Explanation*** : ***No credit shall be given for any capital profit (sale proceeds less original cost) on sale of fixed assets. However, credit shall be given for revenue profit (difference between original cost and written-down value) on sale of fixed assets.***

Example: Original cost of Plant and machinery ₹ 1,00,000. Written-down value — ₹ 60,000; Plant was sold for: Case 1 — ₹ 1,10,000; Case 2 — ₹ 90,000.

Case 1 : Here, total profit = ₹ 1,10,000 – ₹ 60,000 = ₹ 50,000. Out of this ₹ 50,000, ₹ 10,000 (Sales proceeds – original cost) is capital profit and the balance of ₹ 40,000 (original cost – written-down value) is revenue profit. Credit shall be given for ₹ 40,000 (revenue profit). No credit shall be given for ₹ 10,000 (capital profit).

Case 2 : Here, total profit = ₹ 90,000 – ₹ 60,000 = ₹ 30,000. The entire profit is revenue in nature. Therefore, credit shall be given for ₹ 30,000.

Any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in Profit and Loss Account on measurement of the assets or the liability at fair value.

3. ***The following sums shall be deducted*** (Section 198(4):
   (a) all the usual working charges;
   (b) directors' remuneration;
   (c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;
   (d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;
   (e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;
   (f) interest on debentures issued by the company;
   (g) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;
   (h) interest on unsecured loans and advances;
   (i) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;
   (j) outgoings, inclusive of contributions made under Section 181 (***Contribution to bonafide charitable and other funds***);
   (k) depreciation to the extent specified in Section 123. It is to be noted that depreciation shall be provided in accordance with the provisions of Schedule IIof the Companies Act, 2013;
   (l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained;
   (m) any compensation or damages to be paid in virtue of any legal liability, including a liability arising from a breach of contract;
   (n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m); and
   (o) debts considered bad and written-off or adjusted during the year of account.
4. ***The following sums shall not be deducted*** [Section 198(5)]:
   (a) income-tax and super-tax payable by the company under the Indian Income-tax Act, 1961 or any other tax on the income of the company not falling under clauses (d) and (e) of sub-section (4);
   (b) any compensation, damages or payments made voluntarily, that is to say otherwise than in virtue of a liability such as is referred to in clause (m) of sub-section (4); and

(c) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed, over its sale proceeds or its scrap value.

(d) any change in carrying amount of an asset or of a liability recognised in equity reserves and surplus in Profit or Loss Account on measurement of the asset or of the liability at fair value.

Illustration 8

From the following particulars of Ganga Limited, you are required to calculate the managerial remuneration in the following situations :

(i) There is only one whole time director;
(ii) There are two whole time directors;
(iii) There are two whole time directors, a part time director and a manager.

	₹
Net profit before provision for income tax and managerial remuneration, but after depreciation and provision for repairs:	9,20,410
Depreciation as per Schedule II of the Companies Act, 2013	3,10,000
Provision for repairs of machinery during the year	25,000
Actual expenditure incurred on repairs during the year	15,000

Solution

For calculating managerial remuneration, first of all, the profits as per Section 198 of the Companies Act, 2013 have to be calculated in the following manner :

Calculation of Profits for the Purpose of Managerial Remuneration

Particulars	₹
Net Profit before provision for income tax and managerial remuneration but after depreciation and provision for repairs	9,20,410
Add: Provision for repairs of machinery during the year	25,000
	9,45,410
Less: Actual expenditure incurred on repairs during the year	15,000
Profit under Section 198 of the Companies Act, 2013'	9,30,410

Calculation of Managerial Remuneration

(i) There is only one whole time director :

If there is only one whole time director, the maximum limit for managerial remuneration is 5% of net profit (calculated as per the Provision of Section 198).

Therefore, the managerial remuneration will be : 5% of ₹ 9,30,410 = ₹ **46,520.50**.

(ii) There are two whole time directors :

If there are two whole time directors, the maximum limit for managerial remuneration is 10% of net profit (calculated as per the Provision of Section 198).

Therefore, the managerial remuneration will be : 10% of ₹ 9,30,410 = ₹ **93,041.00**.

(iii) There are two whole time directors, a part time director and a manager :

If there are two whole time directors, a part time director and a manager, the maximum limit for managerial remuneration is 11% of net profit (calculated as per the Provision of Section 198).

Therefore, the managerial remuneration will be 11% of ₹ 9,30,410 = ₹ **1,02,345.10**.

Illustration 9

Calculate the managerial remuneration from the following particulars of Ankit and Company Ltd due to the managing director of the company at the rate of 5% of the profits. Also determine the excess remuneration paid, if any :

	₹
Net Profit	2,05,000
Net Profit is calculated after considering the following :	
Depreciation	40,000
Preliminary expenses	10,000
Tax provision	3,10,000
Director's fees	8,000
Bonus	15,000
Profit on sale of fixed assets (original cost : ₹ 20,000, written down value : ₹ 11,000)	15,500
Provision for doubtful debts	9,000

Scientific research expenditure (for setting up new machinery)	20,000
Managing Director's remuneration paid	30,000
Other information :	
Bonus liability as per Payment of Bonus Act, 1965	18,000

Solution

For calculating managerial remuneration, first of all, the profits as per Section 198 have to be calculated in the following manner :

Calculation of Profits for the Purpose of Managerial Remuneration

Particulars	₹	₹
Net Profit		2,05,000
Add: Preliminary expenses	10,000	
Tax provision	3,10,000	
Bonus (to be treated separately)	15,000	
Provision for doubtful debts	9,000	
Scientific research expenditure (Note 1)	20,000	
Managing Director's remuneration	30,000	3,94,000
		5,99,000
Less: Bonus liability as per Payment of Bonus Act, 1965	18,000	
Capital profit on sale of fixed assets (Note 2)	6,500	24,500
Profit under Section 198		5,74,500

Calculation of Managerial Remuneration

Particulars	₹
Remuneration payable to Managing Director @ 5% of ₹ 5,74,500	28,275
Remuneration already paid to Managing Director	30,000
Excess Amount Paid	1,275

Working Notes :

(1) Cost of setting up new machinery for scientific research is a capital expenditure. Therefore, it will not be treated as allowable expenses for computing managerial remuneration. At the time of calculation of profit, it was deducted from Gross Profit. So, it is to be added back.

(2) Calculation of Capital Profit on Sale of Fixed Assets

Particulars	₹
Sales Price (W.D.V. + Profit on sale, i.e., ₹ 11,000 + ₹ 15,500)	26,500
Less : Cost price (original)	20,000
Capital Profit	6,500

Illustration 10

H.P. Ltd. employs a managing director who is entitled to a salary of ₹ 5,000 per month and, in addition, to a commission of 1% of the net profits before charging such salary and commission. The following Statement of Profit and Loss is presented by H.P. Ltd. for the year ended 31st March, 2017.

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹)
I. Gross Profit		10,00,000
II. Profit on Sale of Plant (Cost ₹ 2,50,000; W.D.V. ₹ 1,80,000)		1,00,000
III. Subsidy from Central Government		4,00,000
IV. Total Revenue		15,00,000
IV. **Expenses :**		
Employee Benefits Expenses — Staff Salaries and Bonus		3,00,000
Finance Costs — Interest on Debentures		20,000
Depreciation and Amortization Expenses		1,50,000
Other Expenses		3,65,000
Total Expenses	(1)	8,35,000
VI. Profit before Tax (IV – V)		6,65,000
VII. Tax Expense		
(1) Current Tax		3,32,500
VIII. Profit (Loss) for the period (VI + VII)		3,32,500

Notes to Accounts :

(1) Other Expenses

Particulars	₹
(a) General expenses	1,50,000
(b) Repairs to buildings	30,000
(c) Directors' fees	10,000
(d) R&D expenses (cost of an instrument)	25,000
(e) Ex-gratia payment to an employee	5,000
(f) Bad debts	30,000
(g) Compensation for breach of contract	20,000
(h) Donation to R.K. Mission	30,000
(i) Managing Director's salary	60,000
(j) Debenture Trustee remuneration	5,000
	3,65,000

You are required to calculate the commission payable to managing director. You may assume the depreciation appearing in the Statement of Profit and Loss has been calculated in accordance with Schedule II to the Companies Act, 2013.

Solution

For calculating managing director's remuneration, first of all, the profits as per Section 198 have to be calculated in the following manner :

It can be calculated by taking any of the following as the base :

(a) Net Profit

(b) Gross Profit

(a) Taking Net Profit as the Base

When Net Profit is taken as the base:

Add : All disallowed expenses, e.g., capital expenditure, income tax, managing director's salary, etc.

Less: Disallowed credit, e.g., capital profit on sale of fixed assets, etc.

Calculation of Profits for the Purpose of Managerial Remuneration

Particulars	₹	₹
Net Profit		3,52,500
Add: Cost of apparatus for Research and Development	25,000	
Ex-gratia payment to an employee	5,000	
Managing Director's salary	60,000	
Income tax	3,32,500	4,22,500
		7,55,000
Less: Capital profit on sale of Plant (Note 1)		30,000
Profit under Section 198		7,25,000

Alternatively,

(b) Taking Gross Profit as the Base

When Gross Profit is taken as the base :

Add : Allowed credit

Less: Allowed expenses

Calculation of Profits for the Purposes of Managerial Remuneration

	Notes	₹	₹
Gross Profit as per Profit & Loss A/c			10,00,000
Add: Subsidy from Central Government		4,00,000	
Add: Revenue profit on sale of plant	(1)	70,000	4,70,000
			14,70,000
Less: Sums to be deducted as per rules:			
Staff salaries & bonus		3,00,000	
General expenses		1,50,000	
Repairs to buildings		30,000	
Directors' fees		10,000	
Depreciation		1,50,000	
Bad debts		30,000	
Compensation for breach of contract		20,000	
Donation to R.K. Mission		30,000	
Interest on debentures		20,000	
Debenture trustee remuneration		5,000	7,45,000
Profit under Section 198			7,25,000
Commission payable to the Managing Director (@ 1% on ₹ 7,25,000)			7,250

Tutorial Note: Cost of research equipment, ex-gratia etc., are not treated as allowable expenses for computing managerial remuneration.

As per the provision of Section 197 of the Companies Act, 2013, maximum remuneration (salary + commission) payable to a managing director is limited to 5% of the net profits of the company. Prior approval of the Central Government is required for any excess amount.

Here, Salary and commission payable (₹ 60,000 + ₹ 7,250)	= ₹ 67,250
5% of the Net Profit (5/100 × ₹ 7,25,000)	= ₹ 36,250
Excess	31,000

Prior approval of the Central Government is required in respect of the excess amount of ₹ 31,000. Otherwise the managing director is to refund (₹ 60,000 – ₹ 36,250) = ₹ 23,750.

Working Note:

(1) Calculation of Revenue profit on sale of plant	₹
Sales price (W.D.V. + Profit on sale, i.e., ₹ 1,80,000 + ₹ 1,00,000)	2,80,000
Less: Cost price (original)	2,50,000
Capital Profit	30,000
Revenue profit (Total profit – Capital profit)	70,000

Illustration 11

The Managing Director of Desi Manufacturing Ltd. is entitled to a commission of 5% on the profits before charging such commission.

The following details are available for the year ending 31st March 2017.

(i) Net profits before charging the commission — ₹ 31,70,000.

(ii) The following had been charged off against the profits as determined in (i) above

(a) Depreciation on fixed assets ₹ 14,50,000 (calculated as per Schedule II of the Companies Act, 2013);

(b) Provision for bad and doubtful debts ₹ 16,000.

(iii) Other relevant information:

Bad debts during the year ₹ 57,000.

Calculate the commission payable to the managing director.

Solution **Calculation of Commission Payable to Managing Director**

	₹
Net Profit before charging commission	31,70,000
Add: Provision for doubtful debts	16,000
	31,86,000
Less: Bad debts during the year	57,000
Profit on which commission is payable	31,29,000
Commission payable = ₹ 31,29,000 x 5/100 = ₹ 1,56,450.	

Illustration 12

Determine the maximum remuneration available to the managing director of B Ltd. (a manufacturing company) from the following particulars:

Before charging any such remuneration, the Statement of Profit and Loss showed a profit of ₹ 23,10,000 for the year ended 31st March, 2017 after taking into account the following matters:

Particulars	₹	Particulars	₹
(a) Capital expenditure	5,25,000	(b) Subsidy from Govt.	4,20,000
(c) Special depreciation	70,000	(d) Multishift Depreciation	1,05,000
(e) Bonus to foreign technicians	3,15,000	(f) Provision for taxation	28,00,000
(g) Compensation paid to injured workman	70,000	(h) Ex-gratia to an employee	35,000
(i) Loss on sale of fixed assets	70,000	(j) Profit on sale of investments	2,10,000

Company is providing depreciation as per Schedule II to the Companies Act, 2013.

Solution **Calculation of Managerial Remunmeration**

	₹	₹
Net Profit before charging commission		23,10,000
Add: Capital expenditure	5,25,000	
Special depreciation (Note 2)	70,000	
Provision for taxation	28,00,000	
Ex-gratia to an employee (Note 1)	35,000	34,30,000
		57,40,000
Less: Profit on sale of investments		2,10,000
Net Profit for calculation of managerial remuneration		55,30,000
Managing Directors' remuneration 5%		2,76,500

Tutorial Note: **(1)** Ex-gratia is not treated as allowable expense for computing managerial remuneration.
(2) Multiple shift depreciation is allowable but special depreciation is not allowable.

Illustration 13

Home Appliances Limited employs a manager who is entitled to a salary of ₹ 8,000 per month and, in addition, to a commission of 2% of the net profits determined before charging such salary and commission. The Profit and Loss Account for the company's financial year ending 31st March, 2017 is given below:

Particulars	₹	Particulars	₹
To General expenses	2,52,000	By Gross Profit	27,08,000
To Staff salaries and bonus	6,68,000		
To Depreciation	2,00,000		
To Provision for bad debts	20,000		
To Manager's salary	96,000		
To Commission to manager (on account)	20,000		
To Income-tax	3,40,000		
To Balance c/d	11,12,000		
	27,08,000		27,08,000

The amount charged against provision for bad debts has been arrived at as follows:	₹
Closing balance required in provision for bad debts (as on 31.3.2017)	30,000
Add: Bad debts during the year	10,000
	40,000
Less: Provision available as on 1.4.2016	20,000
	20,000

You may assume that the depreciation shown in the Profit and Loss Account is the amount required to be provided for the purpose of managerial remuneration.

According to the Companies Act, the total of salary and commission payable to the manager cannot exceed 5% of the profits. If the company wants to obtain the approval of the Central Government for any amount payable in excess of that stipulated under the Companies Act.

You are required to calculate the amount in respect of which approval must be obtained from the Central Government.

Solution **Calculation of Profit for the Purposes of Managerial Remuneration**

	₹	₹
Profits as per Profit & Loss A/c		11,12,000
Add: Provision for bad debts	20,000	
Manager's salary	96,000	
Commission to Manager	20,000	
Income-tax	3,40,000	4,76,000
		15,88,000
Less: Bad debts		10,000
Profit under Section 198		15,78,000

Alternatively,

Computation of Profit for the Purposes of Managerial Remuneration

	₹	₹
Gross Profit		27,08,000
Less: General expenses	2,52,000	
Staff salaries & bonus	6,68,000	
Depreciation	2,00,000	
Bad debts	10,000	11,30,000
Profit under Section 198		15,78,000
Commission @ 2% on ₹ 15,78,000		31,560
Add: Salary		96,000
Total salary and commission payable		1,27,560
Maximum remuneration payable under Companies Act, 1956 @ 5% on ₹ 15,78,000		78,900
Excess for which approval is required		48,660

Commission after Charging such Commission

As per the provision of the Companies Act, commission to managerial staff should be calculated ***before charging such commission***. However, a company may enter into an agreement to pay commission at a percentage of profit after charging such commission. In this case commission is calculated as follows:

$$\text{Commission} = \text{Profit before Commission} \times \frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

The following example will explain the above.

Illustrative Example

Net profit before tax and managerial remuneration ₹ 7,80,000

The manager is entitled to a commission @ 4% on net profit after charging such commission. Calculate the commission payable to the manager.

Solution

$$\text{Commission} = \text{Profit before Commission} \times \frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

$$= 7{,}80{,}000 \times \frac{4}{104} = \text{₹ } \mathbf{30{,}000}$$

Alternatively,

Let commission = x

x = 4% of (₹ 7,80,000 – x)

or x = ₹ 31,200 – .04 x

or 1.04 x = ₹ 31,200

or x = ₹ 30,000.

Commission Payable to More than One Member of Managerial Staff

When a company is managed by the part-time directors only (without whole-time director(s) or managing director or manager), the part-time directors put together can get maximum commission @ 3% of the net profits of the company. In any other case it is restricted to 1% of the net profits. But when a company is managed by more than one whole-time directors and other part-time directors, the whole-time directors together can get 10% of the net profits and the part-time directors together can get 1% of the net profits.

Commission payable to each group is calculated independently without deducting the commission of the other. For example, commission payable to two whole-time directors @ 10% of net profits and @ 1% of net profits payable to part-time directors. Net profits for managerial remuneration is ₹ 5,00,000. Here the whole-time directors will get 10% of ₹ 5,00,000 = ₹ 50,000 and the part- time directors will get 1% of ₹ 5,00,000 = ₹ 5,000.

However, there may be an agreement that the whole-time directors will get commission at a fixed rate on net profits after the commission of the part-time directors. Again, the part-time directors will get commission at a fixed rate on net profit after the commission of the whole-time directors. In this situation, the commission of each group is calculated with the help of simultaneous equations. The following example further illustrates this.

Illustration 14

Pagadiwala Containers Limited, having three whole-time directors on its board, the others being part-time directors, earned profits during the year ended 31st March, 2017 to the tune of ₹ 2,65,000 after taking into consideration the following:

(i) Depreciation on fixed assets ₹ 47,800 (calculated in accordance with Schedule II of the Companies Act, 2013);

(ii) Provision for Income-tax ₹ 1,22,500;

(iii) Capital expenditure included in general expense charged to Profit and Loss Account ₹ 12,500.

Calculate the maximum remuneration payable to the whole-time directors assuming that the remuneration payable to them is to be calculated on net profits remaining after payment of commission to part-time directors and the commission to part-time directors is to be calculated on net profits remaining after payment of remuneration to the whole-time directors.

Solution **Calculation of Profit for Managerial Remuneration**

Profit as per Profit & Loss A/c		2,65,000
Add: Provision for Income-tax	1,22,500	
Add: Capital expenditure charged to Profit & Loss A/c	12,500	1,35,000
		4,00,000

Maximum remuneration payable to the whole-time directors = 10% of the net profits after charging commission payable to part-time directors. Again maximum commission payable to part-time directors = 1% of the net profits after charging remuneration payable to whole-time directors.

Let, Maximum remuneration to whole-time directors = x and maximum commission to part-time directors = y.

x = 10% of (₹ 4,00,000 – y) ... (1)

y = 1% of (₹ 4,00,000 – x) ... (2)

or x = ₹ 40,000 – .1y ... (1) $\qquad$ y = ₹ 4,000 – .01x ... (2)

or x + .1y = ₹ 40,000 ... (1) $\qquad$ + .01x + y = ₹ 4,000 ... (2)

Multiplying equation (1) by (1) and equation (2) by 100, we get:

x + .1y = ₹ 40,000

$\underline{x + 100y = ₹\ 4,00,000}$ (Substracting)

–99.9y = –3,60,000

or y = ₹ 3,604 (approx.).

Therefore, x = 10% of (₹ 4,00,000 – ₹ 3,604) = ₹ 39,640) (approx.)

Declaration and Payment of Dividend

The profit which is available to shareholders for distribution as dividend is called ***divisible profits***. One of the important function of company accounting is to determine such profit. Judges, lawyers and Chartered Accounts differ as to the proper method of computing divisible profit. The entire amount of profit as disclosed by the Statement of Profit and Loss is not divisible profit. There is no definition of the profits in the Companies Act, nor is there any indication of the manner in which profits of the companies have to be computed for the purposes of declaration of dividend. ***Section 123*** of the Companies Act specify the sources from which dividends can be paid and also makes it compulsory for a company to provide for depreciation before declaration of dividend.

The details of Section 123 of the Companies Act, 2013 is given below :

(1) No dividend shall be declared or paid by a company for any financial year except—

(a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2), or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the provisions of that sub-section and remaining undistributed, or out of both; or

(b) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government:

Provided that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company:

Provided further that where, owing to inadequacy or absence of profits in any financial year, any company proposes to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves, such declaration of dividend shall not be made except in accordance with such rules as may be prescribed in this behalf: Provided also that no dividend shall be declared or paid by a company from its reserves other than free reserves.

(2) For the purposes of clause (a) of sub-section (1), depreciation shall be provided in accordance with the provisions of Schedule II.

(3) The Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared:

Provided that in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

(4) The amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

(5) No dividend shall be paid by a company in respect of any share therein except to the registered shareholder of such share or to his order or to his banker and shall not be payable except in cash:
Provided that nothing in this sub-section shall be deemed to prohibit the capitalisation of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company:
Provided further that any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of the dividend.

(6) A company which fails to comply with the provisions of sections 73 and 74 shall not, so long as such failure continues, declare any dividend on its equity shares.

Declaration of Dividend Out of Reserves

Rule 3 of the Companies (Declearation and Payment of Dividend) rules, 2016 states that :

In the event of inadequacy or absence of profits in any year, a company may declare dividend out of free reserves subject to the fulfillment of the following conditions, namely:—

(1) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the ***three*** years immediately preceding that year:
Provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(2) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(4) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

(5) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year the loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

Preparation of Statement of Profit and Loss and Balance Sheet

In the examination, generally, it is asked to prepare: (a) Statement of Profit and Loss and (b) Balance Sheet. A Trial Balance and additional information is provided. The Trial Balance contains all of the account balances from the ledger. It includes equity, liabilities, assets, expenses and incomes. In this respect, you should remember that :

(1) ***Debit balances*** are usually assets and expenses and these are always shown in the left hand column of the Trial Balance.

(2) ***Credit balances*** are usually incomes, liabilities and equity and these are always shown in the right hand column of the Trial Balance.

(3) ***Income and expenses*** are shown in the Statement of Profit and Loss.

(4) ***Assets, liabilities and equity*** are shown in the Balance Sheet.

(5) ***Additional information*** given by the way of a note have not been recorded in the Ledger Accounts and consequently will require both a debit and a credit entry (which is usually effected by entering them in both 'Statement of Profit and Loss' and 'Balance Sheet'. Accounts appearing in the Trial Balance will be shown in the 'Statement of profit and Loss' or 'Balance Sheet'. No double entry is required for these accounts.

Suggested Steps for Preparation of Statement of Profit and Loss and Balance Sheet

Students may follow the following suggested steps for the preparation of Statement of Profit and Loss and Balance Sheet from a given Trial Balance with some year end adjustments.

Step 1: Set out a proforma of '***Statement of Profit and Loss***' as per Schedule III, Part II. [***See Page 15.25***] Already, you know that Statement of Profit and Loss should be prepared as per Schedule III of the Companies Act, 2013. It is better to write all the items of the format given.

Step 2 : Set out a proforma of '***Balance Sheet***' as per Schedule III, Part I. [***See Page 15.7***] The Balance Sheet is to be prepared as per the format given in Schedule III of the Companies Act, 2013. It is better to write all the items of the format, e.g., main headings as well as line items.

Step 3 : Go down the Trial Balance and identify the items which are to be entered in Statement of Profit and Loss and which are to be entered in the Balance Sheet. Mark those as 'P' and 'B'. In addition, it is useful to mark those values with an asterisk (*) which are to be affected by the additional information (i.e., adjustments).

Step 4 : Prepare '***Notes to Accounts***' according to needs. The different items are to be written first in the respective 'Notes to Accounts'. the aggregate amount is transferred to the Statement of Profit and Loss and Balance Sheet according to situations. [See '***Real Life Focus***' given in different pages of this Chapter to get an idea for preparation of 'Notes to Accounts'.]

Step 5 : Put all items (with the mark 'B') in the 'Notes to Accounts' related to Balance Sheet and put all items (with the mark 'P' in the 'Notes to Accounts' related to Statement of Profit and Loss.

Step 6 : Make necessary year-end adjustments in the values marked with asterisk (*). Since no double entry have been made for these, there will be a double effect on the Final Accounts. Most adjustments will affect both the Balance Sheet and Statement of Profit and Loss (in particular, 'Notes to Accounts').

Step 7 : Calculate 'Profit before expectional, extra-ordinary and tax' by deducting total expenses from total incomes.

Step 8 : Deduct '***Exceptional Items'*** from the profit arrived in step 7 to get the 'Profit before Extraordinary Items and Tax'.

Step 9 : Deduct '***Extraordinary Items***'from the profit arrived in step 8 to get profit before tax.

Step 10 : Deduct tax to get profit after tax. The profit after tax is transferred to ***'Reserve and Surplus'*** showing the details in the 'Notes to Accounts'.

Illustration 15

The following balances have been extracted from the accounting records of V.P. Sugar Limited as at 31st March, 2017 :

Particulars	₹
Sale of Sugar (Net of excise duty)	70,66,041
Other Operating Income (power generation)	1,95,616
Other Income	1,30,088
Cost of Materials Consumed	30,81,842
Increase in Inventories of Finished Goods, W.I.P., etc.	6,96,688
Salaries and Wages	5,19,426
Contribution to P.F. and Gratuity Fund	2,50,000
Depreciation	3,32,593
Amortisation Expenses	1,00,000
Power and Fuel	15,23,312
Rent, Rates and Taxes	13,21,246
Finance Cost	1,97,768
Tax Expenses (including deferred tax)	2,16,818
Paid-up Equity Share Capital of ₹ 10 each	2,71,000

You are required to :

(i) Prepare a Statement of Profit and Loss for the year ended 31st March, 2017.

(ii) Calculate earning per equity share.

Solution

V. P. Sugar Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

	Particulars	Note No.	Figures for the current reporting period
I.	Revenue from operations	(1)	72,61,657
II.	Other income		1,30,088
III.	Total Revenue (I + II)		73,91,745
IV.	Expenses:		
	Cost of materials consumed		30,81,842
	Purchases of Stock-in-Trade		—
	Changes in inventories of finished goods, work-in-progress and Stock-in-Trade	(2)	(6,96,688)
	Employee benefits expense		7,69,426
	Finance costs		1,97,768
	Depreciation and amortization expense	(3)	4,32,593
	Other expenses	(4)	28,44,558
	Total Expenses		66,29,499
V.	Profit before exceptional and extraordinary items and tax (III–IV)		7,62,246
VI.	Exceptional items		—
VII.	Profit before extraordinary items and tax (V–VI)		7,62,246
VIII.	Extraordinary Items		—
IX.	Profit before tax (VII– VIII)		7,62,246
X.	Tax expense (including Deferred Tax)		2,16,818
XI.	Profit (Loss) for the period (IX – X)		5,45,428
XII.	Earnings per Equity Share :		
	Basic and Diluted	(5)	₹ 20.13

Notes to Accounts :

(1) Revenue from Operations

Particulars	₹
Sale of Sugar (Net of excise duty)	70,66,041
Add: Power Generation	1,95,616
	72,61,657

(2) Employee Benefit Expenses

Salaries and Wages	5,19,426
Add: Contribution to P.F. and Gratuity Fund	2,50,000
	7,69,426

(3) Depreciation and Amortisation Expenses

Depreciation	3,32,593
Add: Amortisation Expenses	1,00,000
	4,32,593

(4) Other Expenses

Particulars	₹
Power and fuel	15,23,312
Rent, Rates and Taxes	13,21,246
	28,44,558

(5) Earning per Equity Share

$$= \frac{\text{Profit after tax}}{\text{Weighted Average No. of Equity Share}}$$

= 5,45,428 / 27,100ü9(çlÇ= çi»åñç‡‡UåJâàÏœ = ₹ 20.126

Face Value of Equity Share = ₹ 10.

Illustration 16

The following balances have been extracted from the accounting records of M P Limited as at 31st March, 2017.

Particulars	Reference Notes	₹
Opening Inventory		7,20,000
Purchases	3	43,68,000
Sales Revenue	2	76,90,000
Freight for Goods Purchased		2,38,000
Office Equipments at 1st April, 2016	2,3,4	
Cost		9,20,000
Accumulated Depreciation		1,84,000
Delivery Expenses		4,54,000
Trade Receivables		12,40,000

Provision for Doubtful Debts (1.4.2016)	5	40,000
Bad Debts written off during the Year		30,000
Salaries		4,00,000
Contribution to Provident Fund		40,000
Staff Welfare Expenses		32,000
Rent		1,00,000
Electricity		1,00,000
Repairs to Building		1,50,000
Interest on Loan		10,000

The following further information is available :

(1) Closing Inventory ₹ 9,00,000

(2) During the year some office equipments, which had cost ₹ 40,000 with accumulated depreciation at 1st April, 2016 of ₹ 28,000 was sold for ₹ 30,000. The sale proceeds were included in the sales figures of ₹ 76,90,000.

(3) The cost of new equipment purchased on 1st October, 2016 for ₹ 1,20,000 has been included in the purcahses figure of ₹ 43,68,000.

(4) The company depreciates its office equipments at 20% p.a. on the straight line basis, with proportionate depreciation in the year of purchase but none in the year of sale. None of the equipments was more than three years' old as on 1st April, 2016.

(5) The provision for doubtful debts at 31st March, 2017 is to be 5% of trade receivables.

(6) Outstanding and prepaid expenses on 31st March, 2017 were :

	₹
Outstanding electricity expenses	7,400
Outstanding building repair expenses	50,000
Prepaid rent	28,800

(7) The directors proposed a dividend of ₹ 6 per equity share (40,000 equity shares of ₹ 10 each)

You are required :

(i) To prepare a Statement of Profit and Loss for the year ending on 31st March, 2017.

(ii) State the amount of proposed dividend and explain how it would be dealt with in the Balance Sheet of the company as at 31st March, 2017 (Ignore tax).

Solution

M P Limited

(i) Statement of Profit and Loss for the year ended 31st March, 2017

	Particulars	Note No.	Figures for the current reporting period
I.	Revenue from operations	(1)	76,60,000
II.	Other income		—
III.	Total Revenue (I + II)		76,60,000
IV.	Expenses:		
	Cost of materials consumed		—
	Purchases of Stock-in-Trade	(3)	44,86,000
	Changes in inventories of finished goods, work-in-progress and Stock-in-Trade (9,00,000 – 7,20,000)		(1,80,000)
	Employee benefits expense	(4)	4,72,000
	Finance costs		10,000
	Depreciation and amortization expense	(5)	1,88,000
	Other expenses	(6)	8,84,600
	Total Expenses		58,60,600
V.	Profit before exceptional and extraordinary items and tax (III – IV)		17,99,400
VI.	Exceptional items (Profit on Sale of Equipments)		18,000
VII.	Profit before extraordinary items and tax (V + VI)		18,17,400
VIII.	Extraordinary Items		—
IX.	Profit before tax (VII– VIII)		18,17,400
X.	Tax expense:		
	(1) Current tax		—
	(2) Deferred tax		—
XI.	Profit (Loss) for the period		18,17,400

Notes to Accounts :

(1) Revenue from Operations

Particulars	₹
Sales Revenue	76,90,000
Less: Sale proceeds of equipments	30,000
	76,60,000

(2) Profit on Sale of Equipments

Cost b/f	40,000
Less: Accumulated Depreciation	28,000
Net Book Value	12,000
Sale Proceeds	30,000
Less: Net Book Value	12,000
Profit on Sale of Office Equipments	18,000

(3) Purchase of Stock-in-Trade

Purchases (as given)	43,68,000
Add: Freight for Goods Purchased	2,38,000
	46,06,000
Less: Cost of Office Equipments includied in Purchases	1,20,000
	44,86,000

(4) Employee Benefits Expenses

Particulars	₹
Salaries	4,00,000
Contribution to P F	40,000
Staff Welfare Expenses	32,000
	4,70,000

(5) Depreciation on Office Equipment

20% (9,20,000 – 40,000)	1,76,000
20% x 1,20,000 x 6/12	12,000
	1,88,000

(6) Other Expenses

Rent	1,00,000	
Less: Prepaid	28,800	71,200
Electricity	1,00,000	
Add: Outstanding	7,400	1,07,400
Building Repairs	1,50,000	
Add: Outstanding	50,000	2,00,000
Bad Debts (written-off)		30,000
Delivery Expenses		4,54,000
Provision for Bad Debts		
New	26,000	
Old	4,000	22,000
		8,84,600

(ii) The amount of proposed dividend of ₹ 2,40,000 will be shown in the Balance Sheet as '***Short-term Provisions***' under '***Current Liabilities***'. It is deducted from profit after tax of the current year. It is treated as appropriation and is shown in the Notes to Accounts for '***Reserve and Surplus***'.

Tutorial Note : Profit on sale of equipments has been treated as exceptional item assuming that it is material and falls under ordinary activity of the Company. ***Alternatively,*** it can be included in '***Other Income***'.

Illustration 17

From the list of following assets and liabilities, prepare the Balance Sheet of the company as per Schedule III, Part I of the Companies Act, 2013 :

Nishant Company Ltd.

Liabilities		₹	Assets		₹
Sundry Creditors		1,00,000	Cash at Bank		79,800
General Reserve		50,000	Cash in Hand		1,500
Interest on Debentures		28,000	Investments – Long-term		95,000
Authorised Share Capital			Preliminary Expenses		9,000
1,20,000 Equity shares of ₹ 10 per share		12,00,000	Current Assets, Loans and Advances		95,000
Subscribed Capital			Goodwill		50,000
80,000 shares of ₹ 10 each	8,00,000		Buildings		6,00,000
Less: Calls-in-Arrears	15,000	7,85,000	Plant and Machinery	6,60,000	
Profit and Loss Account		75,000	Less: Depreciation	66,000	5,94,000
6% Debentures		6,00,000	Stock		10,000
Bills Payable		76,000	Debtors	1,74,000	
			Less: Prov. for Doubtful Debts	8,700	1,65,300
			Furnitures		14,400

Solution

Nishant Company Ltd.
Balance Sheet as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,85,000
(b) Reserves and Surplus	(2)	1,16,000

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities : (a) Long-term Borrowings — 6% Debentures		6,00,000
(4) Current Liabilities : (a) Trade Payables (b) Other Current Liabilities — Interest on Debentures (c) Short-term Provisions	(3)	1,76,000 28,000 —
TOTAL		17,05,000
II. ASSETS **(1) Non-current Assets** : (a) Fixed Assets (i) Tangible Assets (ii) Intangible Assets — Goodwill (b) Non-current Investments	(4)	12,08,400 50,000 95,000
(2) Current Assets : (a) Inventories (b) Trade Receivables (c) Cash and Cash Equivalents (d) Other Current Assets	(5) (6)	10,000 1,65,300 81,300 95,000
TOTAL		17,05,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
1,20,000 Equity Shares of ₹ 10 each		12,00,000
Subscribed Capital :		
(i) Subscribed but not fully paid :		
80,000 Shares of ₹ 10 each	8,00,000	
Less: Calls-in-arrear	15,000	7,85,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	50,000
Profit and Loss Account	75,000
Less: Preliminary Expenses	(9,000)
	1,16,000

(3) Trade Payables

Particulars	₹
Trade Creditors	1,00,000
Bills Payable	76,000
	1,76,000

(4) Fixed Assets — Tangible

Particulars		₹
Buildings		6,00,000
Plant and Machinery	6,60,000	
Less: Depreciation	66,000	5,94,000
Furniture		14,400
		12,08,400

(5) Trade Receivables

Particulars	₹
Trade Debtors	1,74,000
Less: Provision for Doubtful Debts	8,700
	1,65,300

(6) Cash and Cash Equivalents

Particulars	₹
Cash in Hand	1,500
Cash at Bank	79,800
	81,300

Illustration 18

H Ltd. was incorporated with an authorised capital of ₹ 2,00,00,000, consisting of 10,00,000 equity shares of ₹ 10 each and 1,00,000, 8% preference shares of ₹ 100 each.Other details were as follows :

Issued, subscribed and paid-up capital :

	₹
5,00,000 Equity Shares of ₹ 10 each	50,00,000
50,000, 8% Preference Shares of ₹ 100 each	50,00,000
	1,00,00,000

The Statement of Profit and Loss of the company for the year ended 31st March, 2017 showed net profit before tax ₹ 30,00,000. The net profit brought forward from previous year's Balance Sheet amounted to ₹ 6,00,000. The company makes a provision of 30% for income tax.

The following appropriation was proposed by the Company :

(a) to pay dividend on preference shares;
(b) to pay final dividend @ 20% to equity shareholders;
(c) transferred to general reserve ₹ 2,10,000.

You are required to show the relevant items in the Balance Sheet (showing details in the 'Notes to Accounts').

Balance Sheet of H Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,00,00,000
(b) Reserves and Surplus	(2)	10,20,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Provisions	(3)	25,80,000
TOTAL		

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,00,000 Equity Shares of ₹ 10 each	1,00,00,000
1,00,000, 8% Preference Shares of ₹ 100 each	1,00,00,000
	2,00,00,000
Issued, Subscribed and Paid-up Capital :	
5,00,000 Equity Shares of ₹ 10 each fully paid	50,00,000
50,000, 8% Preference Shares of ₹ 100 each fully paid	50,00,000
	1,00,00,000

(2) Reserve and Surplus

Particulars		₹
(a) Profits carried forward from previous year		6,00,000
(b) Profit for the current year after tax (Note 1)	21,00,000	
Less: Appropriations :		
(i) Preference Dividend Paid @ 8%	(4,00,000)	
(ii) Equity Dividend (₹ 2 x 5,00,000)	(10,00,000)	
(iii) Corporate Dividend Tax 20% of ₹ 14,00,000)	(2,80,000)	
(iv) Transfer to General Reserve	(2,10,000)	2,10,000
(c) General Reserve		2,10,000
		10,20,000

(3) Short-term Provisions

Particulars	₹
(i) Proposed Dividend :	
(a) Preference Dividend	4,00,000
(b) Equity Dividend	10,00,000
(ii) Corporate Dividend Tax (20% of ₹ 14,00,000)	2,80,000
(iii) Provision for Taxation (30% of ₹ 30,00,000)	9,00,000
	25,80,000

Working Note : (1)

	₹
Profits before tax	30,00,000
Less: Income-tax @ 30% ON ₹ 30,00,000	9,00,000
Profits after tax	21,00,000

Illustration 19

State under which head these accounts should be classified in Balance Sheet as per Schedule III of the Companies Act, 2013.

(i) Share application money received in excess of issued share capital.
(ii) Share option outstanding amount.
(iii) Unpaid matured debentures and interest accrued thereon.
(iv) Uncalled liability on shares and other partly paid investments.
(v) Calls unpaid.
(vi) Intangible Assets under development.
(vii) Money received against share warrantt.
(viii) Long-term maturity of finance lease obligation.

Solution

Statement Showing the 'Head' in which the Items to be Shown in the Balance Sheet

S.No.	Items	Head
	Share application money received in excess of issued share capital.	Other Current Liabilities
(i)	Sahre option outstanding amount.	Reserve and Surplus
(ii)	Unpaid matured debentures and interest accrued thereon.	Other Current Liabilities
(iii)	Uncalled liability on shares and other partly paid investments.	It is not to be shown in the Balance Sheet. However, in the 'Notes to Accounts' it is to be disclosed.
(iv)	Calls unpaid.	Share Capital — Notes to Account
(v)	Intangible Assets under development.	Non-current Assets : Fixed Assets
(vi)	Money received against share warrantt.	Shareholders' Fund
(vii)	Long-term maturity of finance lease obligation.	Non-current Liabilities : Long-term Borrowings

Illustration 20

M.H.K. Ltd. is registered with an authorised capital of ₹ 6,00,000, divided into 50,000 equity shares of ₹ 10 each and 10,000, 8% preference shares of ₹ 10 each.

The company issued 40,000 equity shares at par and it was fully subscribed and paid in full.

From the following information, you are required to prepare Balance Sheet as at 31st March, 2017 as per Schedule III of the Companies Act, 2013.

Sl.No.	Particulars		(₹)
1.	Share Capital — 40,000 equity shares of ₹ 10 each fully paid		4,00,000
2.	General Reserve		10,000
3.	Balance of Profit and Loss (Cr.) on 1.4.2016		61,450
4.	10% Debentures (Secured)		1,00,000
5.	Sundry Creditors		70,000
6.	Bills Payable		15,000
7.	Current Year's Profit after tax	1,00,000	
.	Less: Appropriations :		
	Proposed Dividend	(40,000)	
	Corporate Dividend Tax @ 20%	(8,000)	52,000
8.	Provision for Taxation		67,050
9.	Machinery, at Cost		1,00,000
10.	Accumulated Depreciation on Machinery		10,000
11.	Building, at Cost		90,000
12.	Accumulated Depreciation on Building		4,500
13.	Furniture		1,85,000
14.	Goodwill		1,25,000
15.	Sundry Debtors		1,00,000
16.	Bills Receivable		60,000
17.	Short-term Investment		70,000
18.	Cash at Bank and in Hand		63,000
19.	Corporate Dividend Tax not yet paid		6,800
20.	Inventories		45,000

Solution

M.H.K. Ltd.
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus	(2)	1,23,450
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		1,00,000
(4) Current Liabilities :		
(a) Trade Payables	(3)	85,000
(b) Short-term Provisions	(4)	1,15,050
TOTAL		8,23,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	3,60,500
(ii) Intangible Assets — Goodwill		1,25,000
(b) Non-current Investments		
(2) Current Assets :		
(a) Current Investments		70,000
(b) Inventories		45,000
(c) Trade Receivables	(6)	1,60,000
(d) Cash and Cash Equivalents		63,000
TOTAL		8,23,500

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
50,000 Equity Shares of ₹ 10 each		5,00,000
10,000 8% Preference Shares of ₹ 10 each		1,00,000
		6,00,000
Issued Capital :		
40,000 Equity Shares of ₹ 10 each		4,00,000
Subscribed Capital :		
(i) Subscribed and fully paid :		
40,000 Shares of ₹ 10 each		4,00,000

(2) Reserve and Surplus

General Reserve		10,000
Balance of Profit and Loss on 1.4.2016		61,450
Current Year's Profit	1,00,000	
Less: Appropriations :		
Proposed Dividend	(40,000)	
Corporation Dividend Tax	(8,000)	52,000
		1,23,450

(3) Trade Payables

Particulars	₹
Sundry Creditors	70,000
Bills Payable	15,000
	85,000

(4) Short-term Provisions

(a) Proposed Dividend	40,000
(b) Corporate Dividend Tax	8,000
(c) Provision for Taxation	67,050
	1,15,050

(5) Fixed Assets — Tangible

(a) Machinery at Cost	1,00,000	
Less: Accumulated Depreciation	10,000	90,000
(b) Building at Cost	90,000	
Less: Accumulated Depreciation	4,500	85,500
(c) Furniture		1,85,000
		3,60,500

(6) Trade Receivables

Sundry Debtors	1,00,000
Bills Receivables	60,000
	1,60,000

Illustration 21

G. Ltd. was incorporated with an authorised capital of ₹ 1,00,00,000 divided into 8,00,000 equity shares of ₹ 10 each and 2,00,000, 7% preference shares of ₹ 10 each.

From the following information, you are required to prepare a Balance Sheet as at 31st March, 2016 as per Schedule III of the Companies Act, 2013.

Sl.No.	Particulars		(₹)
1.	Share Capital		1,00,00,000
2.	10% Secured Debentures		40,00,000
3.	Goodwill		4,00,000
4.	Prepaid Insurance Premium		1,20,000
5.	Land and Building (at valuation)		1,60,00,000
6.	Plant and Machinery (at Cost)		96,00,000
7.	Accumulated Depreciation on Plant and Machinery		36,40,000
8..	Provision for Taxation		6,60,000
9.	General Reserve		34,20,000
10.	Revaluation Reserve		78,40,000
11.	Securities Premium		14,00,000
12.	Retained Earning — Surplus		48,40,000
13.	Current Year's Profit after Tax	15,00,000	
.	Less: Appropriations :		
.	Preference Dividend	(1,40,000)	
.	Equity Dividend (Interim)	(1,60,000)	
.	Corporate Dividend Tax @ 20% of ₹ 3,00,000	(60,000)	11,40,000
14.	Auditors Fees (Outstanding)		80,000
15.	Current Investment		46,20,000
16.	Inventories		44,00,000
17.	Trade payables		39,00,000
18.	Outstanding Electricity Bill		60,000
19.	Outstanding Debenture Interest		2,00,000
20.	Cash at Bank and in Hand		35,80,000
21.	Trade Receivables		25,20,000
22.	Corporate Dividend Tax (Outstanding)		51,000

Solution

G Ltd.
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,00,00,000
(b) Reserves and Surplus	(2)	1,86,40,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings —10% Debentures (Secured)		40,00,000
(4) Current Liabilities :		
(a) Trade Payables		39,00,000
(b) Other Current Liabilities	(3)	4,00,000
(c) Short-term Provisions — Provision for Income Tax		6,60,000
TOTAL		3,76,00,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,19,60,000
(ii) Intangible Assets — Goodwill		4,00,000
(2) Current Assets :		
(a) Current Investments		46,20,000
(b) Inventories		44,00,000
(c) Trade Receivables		25,20,000
(d) Cash and Cash Equivalents		35,80,000
(e) Other Current Assets — Prepaid Insurance Premium		1,20,000
TOTAL		3,76,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
8,00,000 Equity Shares of ₹ 10 each	80,00,000
2,00,000 7% Preference Shares of ₹ 10 each	20,00,000
	1,00,00,000
Issued Capital :	
8,00,000 Equity Shares of ₹ 10 each	80,00,000
2,00,000, 7% Preference Shares of ₹ 10 each	20,00,000
	1,00,00,000
Subscribed Capital :	
(i) Subscribed and fully paid :	
8,00,000 Equity Shares of ₹ 10 each	80,00,000
2,00,000, 7% Preference Shares of ₹ 10 each	20,00,000
	1,00,00,000

(2) Reserve and Surplus

Particulars		₹
Revaluation Reserve		78,40,000
Securities Premium		14,00,000
General Reserve		34,20,000
Surplus		48,40,000
Current Year's Profit	15,00,000	
Less: Preference Dividend	(1,40,000)	
Less: Equity Dividend (Interim)	(1,60,000)	
Less: Corporate Dividend Tax	(60,000)	11,40,000
		1,86,40,000

(3) Other Current Liabilities

Outstanding audit Fees	80,000
Outstanding Electricity Bill	60,000
Outstanding Debenture Interest	2,00,000
Outstanding Corporate Dividend Tax	60,000
	4,00,000

(4) Tangible Assets

(a) Land and Building (at valuation)		1,60,00,000
(b) Plant and Machinery (at cost)	96,00,000	
Less: Accumulated Depreciation	36,40,000	59,60,000
		2,19,60,000

Illustration 22

Silver Ore Co. Ltd. was formed on 1st April, 2016 with an authorised capital of ₹ 6,00,000 in shares of ₹ 10 each. Of these, 52,000 shares had been issued and subscribed but there were calls-in-arrears on 100 shares. From the following Trial balance as on 31st March, 2017 prepare Statement of Profit and loss and a Balance Sheet as on that date.

Particulars	Dr. (₹)	Cr. (₹)
Cash at Bank	1,05,500	
Share Capital		5,19,750
Plant	40,000	
Sale of Silver		1,79,500
Mines	2,20,000	
Promotional Expenses	6,000	
Interest on Fixed Deposit		3,900
Dividend on Investment less 22% Tax		3,200
Royalties Paid	10,000	
Railway Track and Wagons	17,000	
Wages of Miners	74,220	
Advertising	5,000	
Carriage on Plant	1,800	
Furniture and Buildings	20,900	
Administrative Expenses	28,000	
Repairs	900	
Coal and Oil	6,500	

Cash	530	
Investments in Shares of tin Mines	80,000	
Brokerage on Purchase of Shares in Tin Mines	1,000	
6% fixed Deposit in Syndicate Bank	89,000	
Total	7,06,350	7,06,350

Depreciate Plant and Railway Track and Wagons by 10%, Furniture and Building by 5%. Value of Silver on 31st March, 2017 was ₹ 15,000. On 10th December, 2016 the directors forfeited 100 shares of which only ₹ 7.50 per share had been paid.

Provide Income tax ₹ 20,000. Earning per Share not be calculated.

Solution

Silver Ore Co. Ltd

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period
I. Revenue from operations	(1)	1,79,500
II. Other income	(2)	9,443
III. Total Revenue (I + II)		1,88,943
IV. Expenses:		
Cost of materials consumed		—
Purchases of Stock-in-Trade	(3)	16,500
Changes in inventories of finished goods, work-in-progress and Stock-in-Trade	(4)	(15,000)
Employee benefits expense	(5)	74,220
Finance costs		—
Depreciation and amortization expense	(6)	6,925
Other expenses	(7)	39,900
Total Expenses		1,22,545
V. Profit before exceptional and extraordinary items and tax (III–IV)		66,398
VI. Exceptional items		—
VII. Profit before extraordinary items and tax (V–VI)		66,398
VIII. Extraordinary Items		—
IX. Profit before tax (VII– VIII)		66,398
X. Tax expense:		
Current tax		20,000
XI. Profit (Loss) for the period (IX – X)		46,398

Balance Sheet of Silver Ore Co. Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(8)	5,19,750
(b) Reserves and Surplus		46,398
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Provisions — Provision for Income Tax		20,000
TOTAL		5,86,148
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(9)	2,92,775

(2) Current Assets :		
(a) Current Investments	(10)	81,000
(b) Inventories		15,000
(c) Trade Receivables	(11)	1,95,000
(d) Cash and Cash Equivalents		—
(e) Short-term Loans and Advances		—
(f) Other Current Assets	(12)	2,343
TOTAL		5,86,118

Notes to Accounts :

(1) Revenue from Operations

Particulars		₹
Sale of Silver		1,79,500

(2) Other Income

Interest on Fixed Deposits	3,900	
Add: Outstanding (6% of ₹ 89,000 – 3,900)	1,440	5,340
Dividend on Investment (3,200 / 0.78)		4,103
		9,443

(3) Purchase of Stock-in-trade

Coal and Oil	6,500
Royalties paid	10,000
	16,500

(4) Changes in Inventories of Finished Goods

Opening Stock	—
Less: Closing Stock	15,000
	(15,000)

(5) Employee Benefits Expenses

Wages — Miners	74,220

(6) Depreciation and Amortisation

(i) on Railway Track and Wagons (10% of ₹ 17,000)	1,700
(ii) on Furniture and Building (5% of ₹ 20,900)	1,045
(iii) on Plant [10% of (40,000 + 1,800)	4,180
	6,925

(7) Other Expenses

Administrative Expenses	28,000
Repairs	900
Advertising	5,000
Promotional Expenses	6,000
	39,900

(8) Share Capital

Particulars		₹
Authorised Capital :		
60,000 Equity Shares of ₹ 10 each		6,00,000
Issued :		
52,000 Equity Shares of ₹ 10 each		5,20,000
Subscribed and Paid-Up :		
51,900 Equity Shares of ₹ 10 each	5,19,000	
Add: Shares Forfeited (7.50 x 100)	750	5,19,750

(9) Fixed Assets

(a) Tangible		
(i) Mines		2,20,000
(ii) Railway Track and Wagons	17,000	
Less: Depreciation @ 10%	1,700	15,300
(iii) Plant (40,000 + 1,800 Carriage)	41,800	
Less: Depreciation @ 10%	4,180	37,620
(iv) Building and Furniture	20,900	
Less: Depreciation 5%	1,045	19,855
		2,92,775

(10) Current Investment

Investment in Shares of Tin Mines (at Cost)	80,000	
Add: Brokerage	1,000	81,000

(11) Cash and Cash Equivalent

Cash in Hand	530
Cash at bank	1,05,500
Fixed Deposit with Syndicate Bank	89,000
	1,95,030

(12) Other Current Assets

Accrued Interest on Fixed Deposits	1,440	
Tax Deducted at Source on Dividend	903	2,343

Illustration 23

The following is the Trial Balance of P Ltd.:

Particulars	Debit ₹	Credit ₹
Equity Share Capital of ₹ 10 each	—	3,00,000
Retained Earnings	—	1,60,000
Land	70,000	—
Building at cost	98,000	—
Accumulated Depreciation — Building	—	19,600
Equipment — at cost	1,40,000	—
Inventory	89,000	—
Purchases	6,10,000	—
Discount Received	—	10,000

Discount Allowed	14,500	—
Sales	—	11,00,000
Sales Return	17,500	—
Bills Receivable	1,10,000	—
Bills Payable	—	70,000
Trade Debtors	1,06,000	—
Trade Creditors	—	49,000
Accumulated Depreciation — Equipment	—	28,000
Salaries Payable	—	18,000
Rent Received	—	18,000
Salaries to Staff	2,32,000	—
Repairs and Maintenance	19,000	—
Electricity	80,000	—
Interim Cash Dividend	30,000	—
Provision for Doubtful Debts	—	6,000
Selling Expenses	14,000	—
Freight Inward	20,000	—
Bond Payable	—	1,00,000
Profit on Sale of Land	—	25,000
Cash and Cash Equivalents	2,53,600	—
TOTAL	19,03,600	19,03,600

Additional information :

1. The company was incorporated with an authorised capital of ₹ 10,00,000 divided into equity shares of ₹ 10 each.
2. Inventory as at 31st March, 2017 was ₹ 64,000.
3. Depreciation is to be charged as follows :
   (a) Building at 5% using reducing balance method;
   (b) Equipment at 20% using straight line method.
4. The company had issued bonds on 1st October, 2016. The interest is payable half-yearly on 1st April and 1st October. The rate of interest is 12% p.a.
5. Final dividend of ₹ 15,000 was declared on 31st March, 2017.
6. Income tax rate is 35%. (Ignore corporate dividend tax.)

You are required to prepare :

(i) a Statement of Profit and Loss for the year ended 31st March, 2017.
(ii) a Balance Sheet on the same date.

Solution

P Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹)
I. Revenue from Operations	(1)	10,82,500
II. Other Income	(2)	53,000
III. Total Revenue (I + II)		11,35,500
IV. **Expenses :**		
Purchase of Stock-in-trade	(3)	6,30,000
Changes in Inventories of Finished Goods		25,000
Employee Benefits Expenses		2,32,000
Finance Costs (1,00,000 x 12% for 1/2 year)		6,000
Depreciation and Amortization Expenses	(4)	31,920
Other Expenses	(5)	1,27,500
Total Expenses		10,52,420
V. Profit before Exceptional and Extraordinary Items and Tax (III – IV)		83,080
VI. Exceptional Items		—

VII. Profit before Extraordinary Items and Tax (V – VI)		83,080
VIII. Extraordinary Items		—
IX. Profit before Tax (VII – VIII)		83,080
X. Tax Expense (1) Current Tax (35% of ₹ 83,080) (2) Deferred Tax		 29,078
XI. Profit (Loss) for the period (XI – X)		54,002
XII. Earnings per Equity Share : Basic and Diluted		₹ 1.80

Balance Sheet of P. Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,00,000
(b) Reserves and Surplus	(2)	1,69,002
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Bonds		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(8)	1.19.000
(c) Other Current Liabilities	(9)	39.000
(d) Short-term Provisions — Income-tax		29.078
TOTAL		7.56.080
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(10)	2,28,480
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		64,000
(c) Trade Receivables	(11)	2,10,000
(d) Cash and Cash Equivalents		2,53,600
TOTAL		7,56,080

Working Notes :

(1) Revenue from Operations	₹
Sales	11,00,000
Less: Sales Return	17,500
	10,82,500
(2) Other Income	
(i) Rent received	18,000
(ii) Discount received	10,000
(iii) Profit on sale of land	25,000
	53,000
(3) Purchases of Stock	
Purchases	6,10,000
Add: Freight inward	20,000
	6,30,000
(4) Calculation of Depreciation	
(i) Building — at cost	98,000
Less: Accumulated depreciation	19,600
Written-down value on 1.4.2016	78,400

Depreciation = ₹ 78,400 × 5% = ₹ **3,920**

(ii) Equipment = ₹ 1,40,000 × 20% = ₹ 28,000

Total depreciation = ₹ 3,920 + ₹ 28,000 = ₹ **31,920**.

(5) Other Expenses		
Repairs		19,000
Electricity		80,000
Selling expenses		14,000
Discount allowed		14,500
		1,27,500
(6) Share Capital		
Authorised Capital :		
1,00,000 Equity shares of ₹ 10 each		10,00,000
Issued, Subscribed and Paid-up Capital :		
30,000 Equity shares of ₹ 10 each fully paid		3,00,000
(7) Reserve and Surplus		
Retained earnings		1,60,000
Add: Current year's profit		54,002
		2,14,002
Less: Dividend Paid (30,000 + 15,000)		45,000
		1,69,002
(8) Trade Payable		
(i) Trade Creditors		49,000
(ii) Bills Payable		70,000
		1,19,000
(9) Other Current Liabilities		
Salaries Payable		18,000
Dividend Payable		15,000
Interest on Bonds Payable		6,000
		39,000
(10) Fixed Assets		
(a) Tangible Assets :		
(i) Land		70,000
(ii) Building at cost	98,000	
Less: Accumulated Depreciation	23,500	74,480
(iii) Equipment at cost	1,40,000	
Less: Accumulated Depreciation	56,000	84,000
		2,28,480
(11) Trade Receivables		
(i) Trade Debtors	1,06,000	
Less: Provision for Bad Debts	6,000	1,00,000
(ii) Bills Receivable		1,10,000
		2,10,000

Illustration 24

The following Trial Balance related to Air Bag Co. Ltd. as on 31st March, 2017 :

Particulars	Debit ₹ in Lakhs	Credit ₹ in Lakhs
Equity Share Capital (₹ 10 per share)	—	56.00
5% Debentures (Secured)	—	5.00
Land'	10.00	—
Building	40.00	—
Accumulated Depreciation on Building	—	8.00
Plant	53.00	—
Accumulated Depreciation on Plant	—	29.00
Investment Property	30.00	—
Inventory (1.4.2016)	28.00	—
Trade Receivables	41.00	—
Trade Payables	—	39.00
Cash and Cash Equivalents	10.60	—
Long-term Advance	14.40	—
Retained Earning (1.4.2016)	—	41.35
Dividend paid (incuding tax)	0.80	—
Interest Paid	0.25	—

Sales	—	157.00
Purchases	91.40	—
Salary to Staff	14.00	—
Electricity	0.90	—
Repairs and Maintenance	1.00	—
	335.35	335.35

Additional information :

(1) Inventory at 31st March, 2017 is ₹ 33,90,000. It includes damaged items that had a cost of ₹ 5,50,000. These would require remedial work costing ₹ 2,00,000 before these could be sold for an estimated price of ₹ 4,50,000.

(2) Sales proceeds of an item of plant that was sold in January, 2017 for ₹ 3,00,000 is included in the Sales. The cost of the plant is ₹ 10,00,000 and it had been depreciated by ₹ 4,00,000 at the date of its sale. No other accounting entries for the disposal of the plant have been made, other than recording the proceeds in sales and cash. All plants are depreciated @ 25% p.a. under reducing balance method.

(3) On 1st April, 2016 the land was valued at ₹ 12,00,000. The directors wish this value to be incorporated into the financial statements. The company charges 2% depreciation on cost of building using straight line method.

(4) The company adopts the fair value model for its investment property. Its value at 31st March, 2017 has been assessed by a qualified surveyor at ₹ 20,00,000.

(5) The depreciation for the year to 31st March, 2017 has not yet been accounted for in the draft financial statements.

(6) The directors have estimated the provision for income tax for the year ended 31st March, 2017 at ₹ 1,50,000.

You are required to prepare :

(1) A Statement of Profit and Loss for the year ended on 31st March, 2017.

(2) A Balance Sheet as on that date.

Solution

Air Bag Co. Ltd.

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹ in Lakhs))
I. Revenue from Operations	(1)	154.00
II. Other Income		—
III. Total Revenue (I + II)		154.00
IV. **Expenses :**		
Purchases of Stock-in-trade		91.40
Changes in Inventories of Finished Goods		(2.90)
Employee Benefits Expenses		14.00
Finance Costs		0.25
Depreciation and Amortization Expenses	(5)	5.30
Other Expenses	(7)	14.90
Total Expenses		122.95
V. Profit before Exceptional and Extraordinary Items and Tax (III – IV)		31.05
VI. Exceptional Items		—
VII. Profit before Extraordinary Items and Tax (V – VI)		31.05
VIII. Extraordinary Items		—
IX. Profit before Tax (VII – VIII)		31.05
X. Tax Expense		
(1) Current Tax		1.50
XI. Profit (Loss) for the period (IX – X)		29.55
XII. Earnings per Equity Share : Basic and Diluted		₹ 5.28

Balance Sheet of Air Bag Co. Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹ in Lakhs)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(10)	56.00
(b) Reserves and Surplus	(11)	72.10
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		5.00
(4) Current Liabilities :		
(a) Short-term Borrowings		39.00
(b) Trade Payables		1.50
TOTAL		173.60
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(12)	76.70
(b) Long-term Loans and Advances		14.40
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(2)	30.90
(c) Trade Receivables		41.00
(d) Cash and Cash Equivalents		10.60
TOTAL		173.60

Working Notes :

(1) Revenue from Operations		₹ in Lakhs
Sales		157.00
Less: Sales Proceeds of Plant		3.00
		154.00
(2) Value of Closing Inventory		
Value of inventory before adjustment		33.90
Less: Cost of damaged goods		5.50
		28.40
Add : net Realisable Value of damaged goods :		
Estiamted Selling price	4.50	
Less: Cost of Rework	2.00	2.50
		30.90
(3) Change in Inventories of Finished Goods		
Opening Inventories		28.00
Less: Closing Inventory		30.90
Change		(2.90)
(4) Employee Benefits Expenses		
Salaries to Staff		14.00
(5) Calculation of Depreciation		
(i) On Plant		
Cost		53.00
Less: Accumulated Depreciation		29.00
W.D.V. on 1.4.2016		24.00
Less : W.D.V. of Plant sold [₹ 10 Lakhs – 4 Lakhs]		6.00
		18.00
Current Depreciation = 25% of ₹ 18 lakhs = ₹ **4.5 lakhs.**		
(ii) On Building		40.00
Less: Accumulated Depreciation		8.00
		32.00
Current Depreciation = 2% of ₹ 40 Lakhs = 0.80 Lakhs		
Total Depreciation to be charged to Statement of Profit and Loss		
On Plant		4.50 Lakhs
On Building		0.80 Lakhs
		5.30 Lakhs

(6) Loss on Sale of Plant

W.D.V. of Plant Sold	6.00 Lakhs
Less: Sale Proceed of Plant	3.00 Lakhs
	3.00 Lakhs

(7) Other Expenses

	₹ in Lakhs
Loss on sale of Plant (Note 6)	3.00
Electricity	0.90
Repairs and Maintenance	1.00
Loss on Investment Property [30,00,000 – 20,00,000)	10.00
	14.90

(8) Value of Land after Revaluation

Opening balance	10.00
Add: Revaluation gain	2.00
	12.00

(9) Revaluation Reserve = ₹ 2.00 lakhs.

(10) Share Capital

Authorised Capital :	
? Equity Shares of ₹ ? each	?
? Preference Shares of ₹ ? each	?
	?
Issued, Subscribed and Paid-up Capital	
5,60,000 Equity Shares of ₹ 10 each	56.00

(11) Reserve and Surplus

(i) Retained Earnings :	
Opening balance on 1.4.2016	41.35
Add: Current year's profit	29.55
	70.90
Less: Dividend paid (including tax)	.80
	70.10
(ii) Revaluation Reserve — Land (Note 9)	2.00
	72.10

(12) Fixed Assets

(a) Tangible Assets :		
(i) Land		12.00
(ii) Investment Property		20.00
(iii) Plant at cost (53 – 10)	43.00	
Less: Accumulated Depreciation (29 – 4 + 4.5)	29.50	13.50
(iv) Building at cost	40.00	
Less: Accumulated Depreciation	8.80	31.20
		76.70

Illustration 25

Airdrop Ltd. was registered with an authorised capital of 1,00,000 equity shares of ₹ 10 each. The following is the Trial Balance as on 31st March, 2017 :

Particulars	Dr. (₹)	Cr. (₹)
Share Capital : 60,000 Equity Shares of ₹ 10 each		6,00,000
Long-term Borrowings from Bank @ 12% interest p.a.		40,000
Trade Creditors		16,000
Buildings	2,50,000	
Plant and Machinery	1,50,000	
Furniture and Fittings	45,000	
Non-Current Investments	40,000	
Income from Investments		4,000
Sale of Products		9,60,000
Sales Return	80,000	
Opening Stock on 1st April, 2016	40,000	
Purchase of Goods	6,64,000	

Purchases Returns		84,000
Discounting Charges	1,250	
Carriage on Goods Purchased	27,800	
Rent and Taxes	12,000	
Trade Debtors	2,40,000	
Interest on Bank Loan	4,000	
Advertisement Expenses	24,000	
Bad Debts	2,000	
Employee Salaries	80,150	
Audit Fees	5,400	
Contribution to P.F. and Gratuity Fund	12,000	
Cash at Bank and in Hand	26,400	
Total	17,04,000	17,04,000

Additional information :

(a) Closing stock as on March 31, 2017 was ₹ 42,500.

(b) Depreciation is to be provided as follows : Furniture and fittings 10%; Plant and machinery 20%; and Building 10%.

(c) Salaries outstanding as on March 31, 2017 were ₹ 12,450.

(d) Create a provision for doubtful debts at 5% on Trade Debtors.

(e) Trade debtors include an amount of ₹ 5,000 due from Mr Aman and Trade creditors include ₹ 3,000 due to Mr Aman.

(f) Provide for income tax (current) ₹ 16,000.

You are required to :

(i) Prepare a Statement of Profit and Loss for the year ended on 31st March, 2017.

(ii) Prepare a Balance Sheet for the same period.

Solution

Airdrop Ltd

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period
I. Revenue from operations	(1)	8,80,000
II. Other income	(2)	4,000
III. Total Revenue (I + II)		8,84,000
IV. Expenses:		
Cost of materials consumed		—
Purchases of Stock-in-Trade	(3)	6,07,800
Changes in inventories of finished goods, work-in-progress and Stock-in-Trade	(4)	(2,500)
Employee benefits expense	(5)	1,04,600
Finance costs	(6)	6,050
Depreciation and amortization expense	(7)	59,500
Other expenses	(8)	55,250
Total Expenses		8,30,700
V. Profit before exceptional and extraordinary items and tax (III–IV)		53,300
VI. Exceptional items		—
VII. Profit before extraordinary items and tax (V–VI)		53,300
VIII. Extraordinary Items		—
IX. Profit before tax (VII– VIII)		53,300
X. Tax expense:		
Current tax		16,000
XI. Profit (Loss) for the period (IX – X)		37,300
XII. Earnings per Equity Share : Basic and Diluted	(8a)	₹ 0.62

Balance Sheet of Airdrop Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(9)	6,00,000
(b) Reserves and Surplus	(10)	37,300
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(11)	40,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(12)	13,000
(c) Other Current Liabilities	(13)	13,250
(d) Short-term Provisions	(14)	16,000
TOTAL		7,19,550
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(15)	3,85,500
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		40,000
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		42,500
(c) Trade Receivables	(16)	2,25,150
(d) Cash and Cash Equivalents	(17)	26,400
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		7,19,550

Notes to Accounts :

(1) Revenue from Operations

	₹
Sale of Products	9,60,000
Less: Sales Return	80,000
	8,80,000

(2) Other Income

	₹
Income from Investments	4,000

(3) Purchase of Stock

	₹
Purchase of Goods	6,64,000
Add: Carriage on Goods Purchased	27,800
	6,91,800
Less: Purchases Return	84,000
	6,07,800

(4) Changes in Inventory of Finished Goods

	₹
Closing Stock of Goods	42,500
Less: Opening Stock	40,000
	2,500

(8a) Earning Per Equity Share

$$= \frac{\text{Profit after tax}}{\text{Weighted Average No. of Equity Shares}} = \frac{37,500}{60,000} = ₹\ 0.62$$

(9) Share Capital

	₹
Authorised Capital :	
1,00,000 Equity Shares of ₹ 10 each	10,00,000
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each	6,00,000

(10) Reserve and Surplus

	₹
Profit and Loss Balance	37,300

(11) Long-term Borrowings

	₹
Borrowing from Bank	40,000

(12) Trade Payable

	₹
Trade Creditors	16,000
Less: Mutual Indebtedness	3,000
	13,000

(5) Employee Benefit Expenses					
Employee Salary		80,150	**(13) Other Current Liabilities**		
Contribution to P.F.		12,000	Outstanding Salaries		12,450
		92,150	Interest on Loan from Bank		800
Add: Outstanding		12,450			13,250
		1,04,600	**(14) Short-term Provisions**		
(6) Finance Costs			Income tax		16,000
Interest on Long-term Borrowings	4,000		**(15) Fixed Assets**		
Add: Outstanding Interest	800	4,800	*Tangible Assets* :		
Discounting Charges		1,250	(i) Building	2,50,000	
		6,050	Less: Depreciation	25,000	2,25,000
(7) Depreciation			(ii) Plant and Machinery	1,50,000	
Building 10%		25,000	Less: Depreciation	30,000	1,20,000
Plant & Machinery		30,000	(iii) Furniture and Fittings	45,000	
Furniture and Fittings 10%		4,500	Less: Depreciation	4,500	40,500
		59,500			3,85,500
(8) Other Expenses			(16) Trade Receivables		
Rent and Taxes		12,000	Trade Debtors		2,40,000
Advertisement Expenses		24,000	Less: Due from Aman		3,000
Bad Debts		2,000			2,37,000
Audit Fees		5,400	Less: Provision for Bad Debts		11,850
Provision for Bad Debts @ 5% (2,40,000 – 3,000)		11,850			2,25,150
		55,250	**(17) Cash and Cash Equivalents**		
			Cash at Bank and in Hand		26,400

Illustration 26

The following Trial Balance was extracted from Big & Co. Ltd. as on 31.3.2017 :

Debits	₹	Credits	₹
Cash in Hand	250	*Authorised Capital:*	
Unpaid Calls	600	15,000 Equity Shares of ₹ 10 each	1,50,000
Income Tax Paid	12,570	*Issued Capital :*	
Trade Debtors	1,27,000	8,000 Equity Shares of ₹ 10 each	80,000
Office Equipment	10,600	Provision for Income Tax	16,900
Motor Expenses	5,000	Profit and Loss Account	44,000
Purchase of Goods	8,72,400	Bank Overdraft	16,000
Motor Vehicles at cost	83,900	Sales Revenue	10,42,000
Stock on 1.4.2016	69,000	Motor Vehicles Depreciation to 31.3.2016	34,000
Travelling Expenses	16,330	Provision for Bad and Doubtful Debts	4,200
Rent and Rates	14,450	Trade Creditors	62,000
Repairs	9,600		
Printing and Stationery	7,900		
Salaries and Wages including P.F.	69,500		
	12,99,100		12,99,100

The following are other particulars :

(i) Debts amounting to ₹ 3,600 are to be written off and provision for Bad and Doubtful Debts is to be increased to ₹ 6,150.

(ii) Trade Debtors include goods supplied on sale or return basis ₹ 4,800. These goods cost ₹ 4,000 and one-half was returned by the customer.

(iii) Stock on 31.3.2017 was ₹ 81,000.

(iv) Motor expenses included licences for the year ending 31.12.2017 which cost ₹ 1,200 and insurance for the year ending 30.9.2017 which cost ₹ 2,000.

(v) Depreciation is to be provided at 20% on original value of Motor Vehicle and 10% on Office Equipment.

(vi) Income tax liability for the year ended 31.3.2016 (A.Y. 2016-17) was agreed ₹ 15,050. For the accounting year 31.3.2017 (A.Y. 2017-18) the provision for taxation would be ₹ 13,500.

Prepare :

(i) Statement of Profit and Loss for the year ended 31st March, 2017.

(ii) Balance Sheet as on that date.

Solution

Big & Co. Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period
I. Revenue from operations	(1)	10,39,600
II. Other income		—
III. Total Revenue (I + II)		10,39,600
IV. Expenses:		
Cost of materials consumed		—
Purchases of Stock-in-Trade		8,72,400
Changes in inventories of finished goods, work-in-progress and Stock-in-Trade	(2)	(14,000)
Employee benefits expense		69,500
Finance costs		—
Depreciation and amortization expense	(3)	17,840
Other expenses	(4)	56,930
Total Expenses		10,02,670
V. Profit before exceptional and extraordinary items and tax (III–IV)		36,930
VI. Exceptional items		—
VII. Profit before extraordinary items and tax (V–VI)		36,930
VIII. Extraordinary Items		—
IX. Profit before tax (VII– VIII)		36,930
X. Tax expense:		13,500
Current tax		
XI. Profit (Loss) for the period (XI + XIV)		23,430
XII. Earnings per Equity Share :		
Basic and Diluted	(5)	₹ 2.93

Balance Sheet of Big & Co. Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(6)	79,400
(b) Reserves and Surplus	(7)	69,280
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(8)	62,000
(c) Other Current Liabilities	(9)	2,480
(d) Short-term Provisions	(10)	13,500
TOTAL		2,26,660
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(11)	42,660
(ii) Intangible Assets		—
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—

(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(2)	83,000
(c) Trade Receivables	(12)	1,14,850
(d) Cash and Cash Equivalents	(13)	(15,750)
(e) Short-term Loans and Advances		—
(f) Other Current Assets	(14)	1,900
TOTAL		2,26,660

Notes to Accounts :

(1) Revenue from Operations

Particulars		₹
Sales Revenue		10,42,000
Less: Goods Supplied on Sale or Return basis (still with customer)		2,400
		10,39,600

(2) Changes in Inventory

Closing Stock		81,000
Add: Goods lying with customer (at cost)		2,000
		83,000
Less: Opening Stock		69,000
		14,000

(3) Depreciation

Motor Vehicles		16,780
Office Equipment		1,060
		17,840

(3) Other Expenses

Motor Expenses (Note 3)		3,100
Travelling Expenses		16,330
Rent and Rates		14,450
Repairs		9,600
Printing and Stationery		7,900
Bad Debts		3,600
Provision for Doubtful Debts :		
New	6,150	
Old	4,200	1,950
		56,930

(5) Earning per Equity Share

$$= \frac{\text{Profit after tax}}{\text{Weighted Average No. of Equity Shares}} = \frac{23,430}{8,000} = ₹\,2.93$$

(6) Share Capital

Authorised Capital		
15,000 Equity Shares of ₹ 10 each		1,50,000
Issued, Subscribed and Paid-up Capital :		
8,000 Equity Shares of ₹ 10 each	80,000	
Less: Calls-in-Arrear	600	79,400

(7) Reserve and Surplus

Particulars		₹
Profit and Loss Account		
As per last Balance Sheet		44,000
Add: Profit for the year		23,430
Add: Excess I.T. Provision for 2015-16 (Note 4)		1,850
		69,280
Less: Appropriations		—
		69,280

(8) Trade Payables

Trade Creditors	62,000

(9) Other Current Liability

Tax to be paid for 2015-16 (Note 3)	2,480

(10) Short-term Provision

Income-tax for the year 2016-17	13,500

(11) Fixed Assets

(i) *Tangible Assets*		
(a) Motor Vehicles	83,900	
Less: Accumulated Depreciation (39,000 + 16,780)	40,780	33,120
(b) Office Equipment	10,600	
Less: Depreciation	1,060	9,540
		42,660

(12) Trade Receivables

Trade Debtors	1,27,000
Less: Goods Sold on Approval Basis	2,400
	1,24,600
Less: Bad Debts	3,600
	1,21,000
Less: Provision for Bad Debts	6,150
	1,14,850

(13) Cash and Cash Equivalents

Cash in Hand	250
Bank Overdraft	(16,000)
	(15,750)

(14) Other Current Assets

Prepaid Licence Fees	900
Prepaid Insurance	1,000

Working Notes :

(1) Total value of goods supplied on sale or return basis = ₹ 4,800. At the time of sending goods, the following entry was passed:

Trade Debtors Account	Dr.	₹ 4,800	
To Sales Account			₹ 4,800

However, half of the goods were returned during the year. When goods were received back, the following entry was passed:

Sales Account	Dr.	₹ 2,400	
To Trade Debtors Account			₹ 2,400

At the end of the year, 1/2 of the goods were lying with customers. At the time of finalisation, the following entry should be passed:

Sales Account	Dr.	₹ 2,400	
To Trade Debtors Account			₹ 2,400

The effect will be:

(i) Sales will be reduced by ₹ 2,400.
(ii) Trade Debtors will be reduced by ₹ 2,400.
(iii) Closing Stock to be increased by ₹ 2,000 (cost of goods with the customers).

	₹
(2) Motor Expenses Incurred	5,000
Less: Prepaid insurance [₹ 2,000 / 12 × 6 months]	(1,000)
Prepaid licence fees [₹ 1,200 / 12 × 9]	(900)
	3,100
(3) Liability for tax for the year 2015-16	15,050
Less: Tax paid for 2015-16 (A.Y. 2016-17)	12,570
Tax to be paid for 2015-16 (A.Y. 2016-17)	2,480
(4) Provision for I.T. 2015-16 (A.Y. 2016-17)	16,900
Less: Actual tax liability for 2015-16 (A.Y. 2016-17)	15,050
Excess I.T. Provision	1,850

Excess I.T. provision will be adjusted in Reserve and Surplus.

Illustration 27

The following balances have been extracted from the books of Kolkata Ltd. as on 31.03.2017:

Particulars	Dr. (₹)	Cr. (₹)
Land and Buildings	51,12,000	
Furniture and Fittings	2,66,000	
Capital Work-in-Progress	98,000	
Calls-in-arrear @ 25 each	50,000	
Cash in hand	10,000	
5% Tax free Govt. Loan (F.V. ₹ 2 Lacs)	1,97,600	
Bills Receivable	2,72,000	
Goodwill	3,20,000	
Trade Debtors	4,16,000	
Trade Creditors		6,12,000
General Reserves		3,00,000
Profit and Loss Account (on 1.4.2016)		1,76,000
Bank Overdraft		2,23,600
Purchases and Returns	48,00,000	1,00,000
Sales and Returns	1,40,000	61,56,000
Advertisement	1,78,800	
Legal Charges	20,000	
Carriage on Goods Purchased	74,000	
Wages and Salaries including P.F.	4,64,000	
Repairs and Trade Expenses	71,200	
Stock on 1.4.2016	9,52,000	
Income-tax (Advance)	56,000	
Interim Dividend Paid	70,000	
Share Capital (Equity Shares of ₹ 10 each)		40,00,000
6% Debentures of ₹ 100 each		20,00,000
Total	1,35,67,600	1,35,67,600

Other information :

(a) Closing Stock was ₹ 10,82,000 at cost, but market value of which was ₹ 12,10,000.
(b) Provision for Doubtful Debts to be created at 5%.
(c) Depreciation for all assets was calculated for the amount of ₹ 2,86,400 for the year 2016-17.

(d) Trade Expenses include ₹ 10,000 for audit fees and ₹ 2,000 paid to the auditor for attending taxation matters of the company.
(e) Calls-in-arrear includes ₹ 4,000 due from Directors.
(f) Directors declared an interim dividend @ 2.5% and recommended the final divided for the amount of ₹ 1,46,260.
(g) Assume dividend tax rate is 20%.
(h) Provide Income of ₹ 70,000 for the year 2016-17.

Prepare :
(i) Statement of Profit and Loss for the year ended 31st March, 2017.
(ii) Balance Sheet as on that date.

Solution

Kolkata Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period
I. Revenue from operations	(1)	60,16,000
II. Other income		10,000
III. Total Revenue (I + II)		60,26,000
IV. Expenses:		
Cost of materials consumed		—
Purchases of Stock-in-Trade	(2)	47,74,000
Changes in inventories of finished goods, work-in-progress and Stock-in-Trade	(3)	(1,30,000)
Employee benefits expense	(4)	4,64,000
Finance costs	(5)	1,20,000
Depreciation and amortization expense		2,86,400
Other expenses	(6)	2,90,800
Total Expenses		58,05,200
V. Profit before exceptional and extraordinary items and tax (III–IV)		2,20,800
VI. Exceptional items		—
VII. Profit before extraordinary items and tax (V–VI)		2,20,800
VIII. Extraordinary Items		—
IX. Profit before tax (VII– VIII)		2,20,800
X. Tax expense:		
Current tax		70,000
XI. Profit (Loss) for the period (IX – X)		1,50,800
XII. Earnings per Equity Share :		
Basic and Diluted	(7)	₹ 0.38

Balance Sheet of Kolkata Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(8)	39,50,000
(b) Reserves and Surplus	(9)	3,32,788
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(10)	20,00,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(11)	6,12,000
(c) Other Current Liabilities	(12)	1,48,750
(d) Short-term Provisions	(13)	2,65,262
TOTAL		73,08,800

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(14)	50,91,600
(ii) Intangible Assets	(15)	3,20,000
(iii) Capital Work-in-progress		98,000
(iv) Intangible Assets under Development		—
(b) Non-current Investments	(16)	1,97,600
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		10,82,000
(c) Trade Receivables	(17)	6,67,200
(d) Cash and Cash Equivalents		(2,13,600)
(e) Short-term Loans and Advances	(18)	56,000
(f) Other Current Assets	(19)	10,000
TOTAL		73,08,800

Notes to Accounts :

(1) Revenue from Operations

Particulars		₹
Sales		61,56,000
Less: Returns		1,40,000
		60,16,000

(2) Purchase of Stock

Purchases		48,00,000
Less: Returns		1,00,000
		47,00,000
Add: Carriage on Goods Purchased		74,000
		44,74,000

(3) Changes in Inventories

Closing Stock (Note 1)		10,82,000
Less: Opening Stock		9,52,000
		1,30,000

(4) Employee Benefit Expenses

Wages and Salaries including P.F.		4,64,000

(5) Finance Cost

Interest on Debentures @ 6% on ₹ 20,00,000		1,20,000

(6) Other Expenses

Advertisement		1,78,800
Legal Charges		20,000
Repairs Expenses	71,200	
Less: Audit fees	10,000	
	61,200	
Less: Paid for tax matter	2,000	59,200
Payment to Auditor :		
Auditor Fees	10,000	
Other matters	2,000	12,000
Provision for doubtful debts [@ 5% on ₹ 4,16,000]		20,800
		2,90,800

(7) Earning Per Equity Share

$$= \frac{\text{Profit after tax}}{\text{Weighted Average No. of Equity Shares}}$$

$$= \frac{1,50,800}{3,95,000} = ₹\ 0.3817$$

(9) Reserve and Surplus

Secured :Particulars			₹
(i) General Reserve			3,00,000
(ii) Profit and loss Account :			
As per last Balance Sheet		1,76,000	
Add: Profit for the year		1,50,800	
		3,26,800	
Less: Appropriation :			
Interim Dividend	98,750		
Proposed Dividend (Final)	1,46,260		
Corporate Dividend Tax (Note 3)	49,002	2,94,012	32,788
			3,32,788

(10) Long-term Borrowings

6% Debentures	20,00,000

(11) Trade Payables

Trade Creditors	6,12,000

(12) Other Current Liabilities

Outstanding Interim Dividend	28,750
Outstanding Interest on Debentures	1,20,000
	1,48,750

(13) Short-term Provisions

Proposed Dividend	1,46,260
Corporate Dividend Tax	49,002
Provision for Taxation	70,000
	2,65,262

(14) Fixed Assets

Tangible :	
Land and Building	51,12,000
Furniture and Fittings	2,66,000
	53,78,000
Less: Accumulated Depreciation (Total)	2,86,400
	50,91,600
Intangible Assets :	
Goodwill	3,20,000

(15) Non-Current Investments

5% Tax-free Govt. Loan	1,97,600

(8) Share Capital			**(16) Trade Receivables**	
Authorised Capital :			Trade Debtors	4,16,000
... Equity Shares of ₹ ... each		***	Less: Provision for Bad Debts	20,800
Issued, Subscribed and Paid-up Capital :				3,95,200
4,00,000 Equity Shares of ₹ 10 each	40,00,000		Bills Receivables	2,72,000
Less: Calls-in-Arrear for Director 4,000				6,67,200
Less: Calls-in-Arrear for Others 46,000	50,000	39,50,000	**(17) Cash and Cash Equivalents**	
			Cash in Hand	10,000
			Bank Overdraft	(2,23,600)
				(2,13,600)
			(18) Short-term Loans and Advances	
			Advance Tax	56,000
			(19) Other Current Assets	
			Accrued Interest	10,000

Working Notes :

(1) Closing Stock is valued at cost or NRV whichever is lower. Here, cost is ₹ 10,82,000 but market value is ₹ 12,10,000. Therefore, value of closing stock will be ₹ 10,82,000.

(2) Dividend is paid on paid-up capital. Here paid-up capital is ₹ 39,50,000.

(i) Interim Dividend @ 2.5% on ₹ 39,50,000	98,750
(ii) Final dividend	1,46,260
	2,45,010

(3) Corporate dividend tax @ 20% on ₹ 2,45,010 = ₹ 49,002.

(4) Bank Overdraft will be treated as cash and cash equivalent as per AS–3 "Cash Flow Statement".

Illustration 28

On 31st March, 2017 the following balances appeared in the books of the Alfa Hotels Ltd :

Debits	₹	Credits	₹
Interest on Debentures	60,000	12% Mortgage Debentures	5,00,000
Rates and Taxes	18,000	Share Capital	40,00,000
Stock of Provisions on 1.4.2016	2,50,000	General Reserve	5,00,000
Purchases of Provisions	25,00,000	Unclaimed Dividends	15,000
Salaries and Wages	9,50,000	Provision for Bad Debts	50,000
Provident Fund Contribution	30,000	Trade Creditors	2,50,000
Miscellaneous Expenses	50,000	Expenses Owing	80,000
Bonus	24,000	Visitors' Credit Balances	10,000
Loss on foreign currency transactions	15,000	Staff Provident Fund	7,50,000
Land	15,00,000	Profit and Loss Account	81,000
Buildings	50,00,000	Income from Board and Lodging	51,00,000
Furniture and Fittings	15,00,000	Miscellaneous Receipts	65,000
Linen, Crockery, Glassware, Cutlery and Utensils	3,20,000	Accumulated Depreciation Account :	
Trade Debtors	3,50,000	Buildings	20,00,000
Prepaid Expenses	25,000	Furniture, etc.	10,00,000
Advance against Purchase of Buildings	15,00,000	Linen, Crockery, etc.	1,80,000
Cash in Hand	15,000		
Balance at Bank	4,74,000		
	1,45,81,000		1,45,81,000

After taking the following information into account, prepare the Company's Balance Sheet as on 31st March, 2017 and its Statement of Profit and Loss for the year then ended :

(i) Stock of provisions on 31st March, 2017 was valued at ₹ 3,00,000.

(ii) Provide for depreciation :
₹ 1,00,000 on furniture and fittings;
₹ 20,000 on linen, crockery, glassware, etc.

(iii) Make a provision for taxation ₹ 4,00,000.

(iv) The directors decide to recommend a dividend @ 10% on the paid-up capital of the Company and transfer the remaining balance on Profit and Loss Account to General Reserve.

(v) The entire paid-up share capital of the Company consists of fully paid equity shares of ₹ 10 each.

[C.S. (Inter) — Adapted]

Solution

This problem has been solved after taking corporate dividend tax @ 20%.

Alfa Hotels Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period
I. Revenue from operations		51,00,000
II. Other income		65,000
III. Total Revenue (I + II)		51,65,000
IV. Expenses:		
Cost of materials consumed		—
Purchases of Stock-in-Trade		25,00,000
Changes in inventories of finished goods work-in-progress and Stock-in-Trade		(50,000)
Employee benefits expense	(1)	10,04,000
Finance costs	(2)	75,000
Depreciation and amortization expense	(3)	1,20,000
Other expenses	(4)	68,000
Total Expenses		37,17,000
V. Profit before exceptional and extraordinary items and tax (III–IV)		14,48,000
VI. Exceptional items		—
VII. Profit before extraordinary items and tax (V–VI)		14,48,000
VIII. Extraordinary Items		—
IX. Profit before tax (VII– VIII)		14,48,000
X. Tax expense:		
Current tax		4,00,000
XI. Profit (Loss) for the period (IX – X)		10,48,000
XII. Earnings per Equity Share :		
Basic and Diluted	(5)	₹ 2.62

Balance Sheet of Alfa Hotels Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(6)	40,00,000
(b) Reserves and Surplus	(7)	11,49,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(8)	5,00,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions	(9)	7,50,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(10)	2,50,000
(c) Other Current Liabilities	(11)	1,05,000
(d) Short-term Provisions	(12)	8,80,000
TOTAL		76,34,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(13)	50,20,000
(ii) Intangible Assets		—
(b) Non-current Investments		—

(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances	(14)	15,00,000
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		3,00,000
(c) Trade Receivables	(15)	3,00,000
(d) Cash and Cash Equivalents	(16)	4,89,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets	(17)	25,00,000
TOTAL		76,34,000

Notes to Accounts :

(1) Employee Benefit Expenses

Particulars	₹
Salaries and Wages	9,50,000
P.F. Contribution	30,000
Wages	24,000
	10,04,000

(2) Finance Cost

Intereset on Debentures	60,000
Loss on Foreign Currency Transaction	15,000
	75,000

(3) Depreciation and Amortisation

Depreciation on Futniture	1,00,000
Depreciation on Linen, Crockery	20,000
	1,20,000

(4) Other Expenses

Miscellaneous Expenses	50,000
Rates and Taxes	18,000
	68,000

(5) Earning per Share

$$= \frac{\text{Profit after tax}}{\text{Weighted Average No. of Equity Shares}}$$

$$= \frac{10,48,000}{4,00,000} = ₹\,10. \qquad \text{Face Value of Share - ₹ 10.}$$

(6) Share Capital

Authorised :		
... Equity Shares of ₹ ... each		***
Issued, and Subscribed :		
4,00,000 Equity Shares of ₹ 10 each fully paid		40,00,000

(7) Reserve and Surplus

General Reserve		
Opening Balance		5,00,000
Add: Transfer from Surplus		6,49,000
		11,49,000
Surplus :		
Opening Balance	81,000	
Add: Net Profit of the current year	10,48,000	
Balance available for appropriation	11,29,000	
Less: Appropriation :		
Proposed Dividend	(4,00,000)	
Corporation Dividend Tax @ 20%	(80,000)	6,49,000
Less: Transferred to General Reserve		6,49,000
		Nil

(8) Long-term Borrowings

Particulars	₹
12% Mortgage Debentures	5,00,000

(9) Long-term Provision

Staff Provident Fund	7,50,000

(10) Trade Payable

Trade Creditors	2,50,000

(11) Other Current Liabilities

Visitor's Current Balances	10,000
Expenses Owing	80,000
Unclaimed Dividend	15,000
	1,05,000

(12) Short-term Provision

Provision for taxation	4,00,000
Proposed Dividend	4,00,000
Corporate Dividend Tax	80,000
	8,80,000

(13) Fixed Assets

Tangible :		
Land		15,00,000
Building (at cost)	50,00,000	
Less: Accumulated Depreciation	20,00,000	30,00,000
Furniture and Fittings	15,00,000	
Less: Accumulated Depreciation	11,00,000	4,00,000
Linen, Crockery, Glassware, etc.	3,20,000	
Less: Accumulated Depreciation	2,00,000	1,20,000
		50,20,000

(14) Long-term Loans & Advances

Advance against purchase of Building	15,00,000

(15) Trade Receiable

Trade Debtors	3,50,000
Less: Provision for bad Debts	50,000
	3,00,000

(16) Cash and Cash Equivalents

Cash in Hand	15,000
Cash at Bank	4,74,000
	4,89,000

(17) Other Current Assets

Prepaid Expenses	25,000

Illustration 29

You are given the following Trial Balance of A Ltd., as on 31st March, 2017:

Debits	₹	Credits		₹
Plant and machinery	1,00,000	Equity share capital (shares of ₹ 10 each)		3,00,000
Land and Building	1,00,000	Profit and Loss Account		3,900
Furniture	8,000	Sale of Products		11,45,000
Trade debtors	90,000	Trade creditors		26,000
Salaries and Wages including P.F.	2,25,000	Income tax (A.Y. 2016-17):		
Investments*	50,000	Provision	11,800	
Patents	1,37,970	Payment	11,500	300
Repairs and maintenance	2,380	Provision for Doubtful debts:		
Interest on debentures	3,000	Opening balance	2,100	
Vehicles	15,000	Less: Bad debts written-off	1,700	
Stationery	780		400	
Conveyance	2,360	Add: Prov. for doubtful debts created	1,100	1,500
Insurance	1,750	General reserve		13,420
Purchase of Goods	8,00,880	Shares Suspense Account		2,000
Security deposits	9,000	12% Debentures		50,000
Income tax for current year	26,000	Sale of Machinery Account		4,000
Carriage on Goods Purchased	3,500	Unclaimed dividend		1,500
Cash	4,500	6% Preference share capital (shares of ₹ 100 each)		50,000
Interim dividend	9,000			
Bank balance	7,500			
Calls-in-arrears (500 shares @ ₹ 2)	1,000			
	15,97,620			15,97,620

*(10,000 eq. sh. of ₹ 10 each in B Ltd. ₹ 5 paid-up)

You are further informed that:

1. After giving due notice, shares on which the calls were in arrears have been forfeited and re-issued and the proceeds were credited to Share Suspense Account.
2. A machine costing ₹ 10,000 on which depreciation of ₹ 5,000 was written-off up to last year was sold on 25th March, 2017 at ₹ 4,000; the proceeds have been credited to Sale of Machinery Account.
3. Original cost of the assets:
   Land ₹ 20,000; Buildings ₹ 1,20,000; Plant and Machinery ₹ 1,20,000; Furniture ₹ 10,000; & Vehicles ₹ 20,000.
4. Depreciation was to be provided on written-down value basis at the following rates:
   Building 5%; Machinery 15%; Vehicles 20%; and Furniture 10%.
5. Provision for doubtful debts created during the year at ₹ 1,100 as shown in the Trial Balance was debited during the year to Profit and Loss Appropriation Account.
6. Income tax assessment for assessment year 2016-17 was completed resulting in a gross demand of ₹ 12,000 and was accepted by the company.
7. Provision for taxation for the current year is to be made at ₹ 20,000.
8. The directors propose to transfer ₹ 10,000 to General Reserve and to declare a final dividend of 10% on equity share capital.
9. Debentures were issued in 2011 on a floating charge of all assets.
10. Corporate dividend tax @ 20%.

Prepare :

(i) Statement of Profit and Loss for the year ended 31st March, 2017.

(ii) Balance Sheet as on that date.

[C.A. (Inter) — Adapted]

Solution

A Ltd.

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period
I. Revenue from operations	(1)	11,45,000
II. Other income		—
III. Total Revenue (I + II)		11,45,000

IV. Expenses:		
Cost of materials consumed		—
Purchases of Stock-in-Trade	(2)	8,04,380
Changes in inventories of finished goods work-in-progress and Stock-in-Trade		—
Employee benefits expense	(3)	2,25,000
Finance costs	(4)	6,000
Depreciation and amortization expense	(5)	22,800
Other expenses	(6)	8,620
Total Expenses		10,66,800
V. Profit before exceptional and extraordinary items and tax (III–IV)		78,200
VI. Exceptional items		—
VII. Profit before extraordinary items and tax (V–VI)		78,200
VIII. Extraordinary Items		—
IX. Profit before tax (VII– VIII)		78,200
X. Tax expense:		
Current tax		20,000
XI. Profit (Loss) for the period (IX – X)		58,200
XI. Earnings per Equity Share :		
Basic and Diluted	(19)	₹ 1.84

Balance Sheet of A Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(7)	3,50,000
(b) Reserves and Surplus	(8)	27,020
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(9)	50,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(10)	26,000
(c) Other Current Liabilities	(11)	5,000
(d) Short-term Provisions	(12)	61,400
TOTAL		5,19,420
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(13)	1,95,950
(ii) Intangible Assets	(13)	1,37,970
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments	(14)	50,000
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets	(15)	9,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables	(16)	88,500
(d) Cash and Cash Equivalents	(17)	12,000
(e) Short-term Loans and Advances	(18)	26,000
(f) Other Current Assets		—
TOTAL		5,19,420

Notes to Accounts :

(1) Revenue from Operations

		₹
Sale of Products		11,45,000

(2) Purchase of Stock-in-Trade

		₹
Purchase of Goods		8,00,880
Add: Carriage on Goods Purchased		3,500
		8,04,380

(3) Employee Benefits Expenses

		₹
Salaries and Wages including P.F.		2,25,000

(4) Finance Cost

		₹
Interest on Debentures		3,000
Add: Outstanding		3,000
		6,000

(5) Depreciation

		₹
Building (Note 2)		4,000
Plant and Machinery (Note 2)		14,250
Vehicles (Note 2)		3,000
Furnitures (Note 2)		800
Machinery (Sold)		750
		22,800

(6) Other Expenses

		₹
Repairs and Maintenance		2,380
Stationery		780
Conveyance		2,360
Insurance		1,750
Provision for Doubtful Debts		1,100
Loss on Sale of Machinery (Note 1)		250
		8,620

(7) Share Capital

		₹
Authorised		
6% Preference Shares of ₹ 100 each		?
... Equity Shares of ₹ 10 each		?
		?
Issued, Susbcribed and Paid-up :		
500, 6% Preference Shares of ₹ 100 each		50,000
30,000 Equity Shares of ₹ 10 each		3,00,000
		3,50,000

(8) Reserve and Surplus

		₹
(i) Capital Reserve (Note 7)		1,000
(ii) General Reserve :		
Opening balance	13,420	
Add: Transfer from Surplus	10,000	23,420
(iii) Profit and Loss Balance :		
Opening balance (Note 3)	5,000	
Less: Provision (Note 8)	200	
	4,800	
Add: Current year's profit	58,200	
	63,000	
Less: Appropriation :		
Trasfer to Reserve	(10,000)	
Interim Dividend	(9,000)	
Proposed Dividend :		
— Preference	(3,000)	
— Equity	(30,000)	
Corporate Dividend Tax @ 20%	(8,400)	2,600
		27,020

(9) Long-term Borrowings

		₹
Secured :		
12% Debentures		50,000

(10) Trade Payable

		₹
Trade Creditors		26,000

(11) Other Current Liabilities

		₹
Unclaimed Dividend		1,500
Income tax Payable (Note 8)		500
Interest Accrued on Debentures		3,000
		5,000

(12) Short-term Provision

		₹
Proposed Dividend		33,000
Provision for Tax		20,000
Corporate Dividend Tax		8,400
		61,400

(13) Fixed Assets

		₹
(i) Tangible		
Land		20,000
Building (at cost)	1,20,000	
Less: Accumulated Depreciation	44,000	76,000
Plant and Machinery	1,10,000	
Less: Accumulated Depreciation	29,250	80,750
Furniture (at cost)	10,000	
Less: Accumulated Depreciation	2,800	7,200
Vehicles (at cost)	20,000	
Less: Accumulated Depreciation	8,000	12,000
		1,95,950
(ii) Intangible		
Patents		1,37,970

(14) Non-Current Investments

		₹
10,000 Equity Shares of ₹ 10 each in B Ltd. ₹ 5 paid-up		50,000

(15) Other Non-Current Assets

		₹
Security Deposit		9,000

(16) Trade Receivable

		₹
Trade Debtors		90,000
Less: Provision for Bad Debts		1,500
		88,500

(17) Cash and Cash Equivalents

		₹
Cash in Hand		4,500
Cash at Bank		7,500
		12,000

(18) Short-term Loans and Advances

		₹
Advance Income Tax		26,000

(19) Earning per Equity Share

$$= \frac{\text{Profit after tax} - \text{Preference Dividend}}{\text{Weighted Average No. of Equity Shares}}$$

$$= \frac{58{,}200 - 3{,}000}{30{,}000} = ₹\ 1.84$$

Face Value of Equity Share = ₹ 10.

Working Notes:

(1) Loss on Sale of Machinery	₹	**(2) Calculation of Depreciation**	₹
Original cost of machine sold	10,000	(i) Building:	
Less: Accumulated depreciation up to 31.3.2016	5,000	W.D.V. (₹ 1,00,000 – ₹ 20,000)	80,000
W.D.V. on 1.4.2016	5,000	Depreciation @ 5% on ₹ 80,000	4,000
Less: Depreciation for 2016-17 (5,000 x 15/100)	750	(ii) Plant & Machinery:	1,00,000
W.D.V. on the date of sale	4,250	W.D.V. on 1.4.2016	5,000
Less: Sale value	4,000	Less: W.D.V. of machinery sold	95,000
Loss on sale	250	Depreciation @ 15% on ₹ 95,000	14,250
(3) Balance of P & L Account as per Trial Bal.	3,900	(iii) Vehicles	
Add: Provision for doubtful debts wrongly charged	1,100	W.D.V. on 1.1.2016	15,000
	5,000	Depreciation @ 20% on ₹ 15,000	3,000
(4) Gross demand for A.Y. 2016-17	12,000	(iv) Furniture	
Less: Provision already made during 2013-15	11,800	W.D.V. on 1.4.2016	8,000
Balance adjusted in Reserve	200	Depreciation @ 10% on ₹ 8,000	800

(5) At the time of providing dividend for equity shares, provision must be made for preference dividend payable also, because preference shares carry a preferential right for dividends.

(6) Calculation of Accumulated Depreciation

	Land	Building	Plant & Machinery	Furniture	Vehicle
Original cost	20,000	1,20,000	1,20,000	10,000	20,000
Less: W.D.V. as on 1.4.2016	20,000	80,000	1,00,000	8,000	15,000
Accumulated depreciation upto 31.3.2016	Nil	40,000	20,000	2,000	5,000
Less: Acc. dep. on machine sold (upto 31.3.2016)	—	—	5,000	—	—
	Nil	40,000	15,000	2,000	5,000
Add: Depreciation for 2016-17	—	4,000	14,250	800	3,000
Total Accumulated Depreciation		44,000	29,250	2,800	8,000

(7) Profit on re-issue of shares will be transferred to Capital Reserve Account. The balance of Share Suspense Account will be transferred to Share Capital Account. The balance of Calls-in-arrears Account will be transferred to Forfeiture Share Account.

Dr. Share Capital Account Cr.

	₹		₹
To Forfeited Shares A/c	5,000	By Balance b/d	3,00,000
To Balance c/d	3,00,000	By Share Suspense A/c	2,000
		By Forfeited Shares A/c (Discount on re-issue)	3,000
	3,05,000		3,05,000

Dr. Share Suspense Account Cr.

To Share Capital A/c	2,000	By Balance b/d	2,000

Dr. Forfeited Share Account Cr.

To Calls-in-arrears A/c	1,000	By Share Capital A/c (500 x 10)	5,000
To Share Capital A/c (Discount)	3,000		
To Capital Reserve A/c (Profit)	1,000		
	5,000		5,000

Dr. Calls-in-Arrear Account Cr.

To Balance b/d	1,000	By Forfeited Shares A/c	1,000

Dr. (8) Provision for Income-Tax Account Cr.

To Advance tax	11,500	By Balance b/d	11,800
To Income tax payable	500	By P/L A/c	200
	12,000		12,000

(9) Corporate Dividend Tax has been computed @ 17% on ₹ 42,000 (9,000 + 3,000 + 30,000) = ₹ 7,140.

Illustration 30

The following Trial Balance relates to M.H. Limited as on 31st March, 2017 :

Particulars	Debit ₹ in Lakhs	Credit ₹ in Lakhs
Equity Shares of ₹ 10 each	—	80.00
Retained Earnings (1.4.2016)	—	27.00
Revaluation Reserve	—	15.00
Deferred Tax	—	5.00
Land and Building — at Valuation on 1.4.2016 (Note 3)	130.00	—
Plant at Cost	125.00	—
Accumulated Depreciation on Plant	—	35.00
Long-term Investment	40.00	—
Income from Investment	—	5.00
Cost of Sales	125.00	—
Inventories on 31.3.2017 (Note 1)	36.00	—
Trade Receivables	33.50	—
Trade Payables	—	40.00
Income tax (Note 2)	—	6.50
Finance Cost	7.50	—
Revenue from Operations	—	273.50
Advertisement Expenses	4.50	—
Salaries to Staff	15.50	—
Electricity	5.00	—
Repairs and Maintenance	3.00	—
Sundry Expenses	2.00	—
Bank (Current Account)	—	40.00
TOTAL	527.00	527.00

The following notes are relevant to M.H. Ltd. :

(1) The company is engaged in supply of FMCG (Fast Moving Cosnumer Goods). At the end of the year management decided to discontinue some of the slow moving goods. The value of these goods are ₹ 3 lakhs and included in the closing inventory of ₹ 36 lakhs. The management is trying to sell these goods at the earliest, the best price that has been offered by a wholeseller is ₹ 1.2 lakhs.

(2) The balance of income tax in the Trial Balance is due to difference in tax provision by the company and assessment by the tax authorities for the year ended on 31st March, 2016.
The estimated income tax liability for the year ended on 31st March, 2017 is 27.5 lakhs.

(3) The company has the policy to revalue its land and building each year end. The value in the Trial Balance includes land components of ₹ 40 lakhs. On 31st March, 2017 the value of the building was ₹ 90 lakhs while value of the land was increased by 20%. The estimated remaining life of building was 30 years on 1.4.2016 which remains same.

(4) The plant is depreciated @ 15% p.a. using reducing method.

You are required to prepare :

(a) Statement of Profit and Loss for the year ended 31st March, 2017.

(b) Balance Sheet as at 31st March, 2017.

Solution

M. H. Limited

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹ in Lakhs)
I. Revenue from Operations		273.50
II. Other Income — Income from Investments		5.00
III. Total Revenue (I + II)		278.50
IV. **Expenses :**		
Cost of Sales	(1)	126.80
Employee Benefits Expenses — Salary to Staff		15.50

Finance Costs (1,00,000 x 12% for 1/2 year)		7.50
Depreciation and Amortization Expenses	(2)	16.50
Other Expenses	(4)	14.50
Total Expenses		180.80
V. Profit before Exceptional and Extraordinary Items and Tax (III – IV)		97.70
VI. Exceptional Items		—
VII. Profit before Extraordinary Items and Tax (V – VI)		97.70
VIII. Extraordinary Items		—
IX. Profit before Tax (VII – VIII)		97.70
X. Tax Expense (1) Current Tax		27.50
XI. Profit (Loss) for the period (XI – X)		70.20
XII. Earnings per Equity Share (1) Basic (2) Diluted		

Balance Sheet of M. H. Limited as at 31st March, 2017

Particulars	Note No.	Amount (₹ in Lakhs)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(5)	80.00
(b) Reserves and Surplus	(6)	129.70
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		—
(b) Deferred Tax Liabilities (Net)		5.00
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		40.00
(c) Other Current Liabilities		—
(d) Short-term Provisions — Income-tax (2016-17)		27.50
TOTAL		282.20
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(7)	214.50
(b) Non-current Investments		40.00
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(8)	34.20
(c) Trade Receivables		33.50
(d) Cash and Cash Equivalents — Bank Overdraft		(40.00)
TOTAL		282.20

Working Notes :

(1) Calculation of Cost of Sales

	₹ in Lakhs
Balance as per Trial Balance	125.00
Add: Slow moving closing stock	3.00
	128.00
Less: Net Realisable Value of slow moving stock	1.20
	126.80

(2) Calculation of Depreciation and Value of Land and Building

Particulars	Land (₹ in Lakhs)	Building (₹ in Lakhs)	Total (₹ in Lakhs)
Cost / Valuation	40.00	90.00	130.00
Current Depreciation (Note 3)	—	3.00	3.00
Book Value before Revaluation	40.00	87.00	127.00
Revaluation	8.00	3.00	11.00
	48.00	90.00	138.00

Calculation of Depreciation and Value of Plant

	Plant (₹ in Lakhs)
Cost / Valuation	125.00
Less: Accumulated Depreciation	35.00
	90.00
Less: Depreciation (Current) @ 15%	13.50
	76.50

(3) Depreciation on Building $= \frac{90 \text{ lakhs}}{30 \text{ years}} = 3$ lakhs

(4) Other Expenses

	₹ in Lakhs
Electricity	5.00
Repairs and Maintenance	3.00
Sundry Expense	2.00
Advertisement Expense	4.50
	14.50

(5) Share Capital

Authorised Capital :	
? Equity Shares of ₹ ? each	?
? Preference Shares of ₹ ? each	?
	?
Issued, Subscribed and Paid-up Capital :	
8,00,000 Equity Shares of ₹ 10 each fully paid	80.00

(6) Reserve and Surplus

(i) Retained Earnings :		
Opening balance	27.00	
Add: Profit of current year	70.20	
Add: Excess Provision for tax (2015-16)	6.50	103.70
(ii) Revaluation Reserve :		
Opening balance	15.00	
Add: Revaluation of land and building	11.00	26.00
		129.70

(7) Fixed Assets :

(a) Tangible Assets :		
(i) Plant at cost	125.00	
Less: Accumulated Depreciation (35 + 13.50)	48.50	76.50
(ii) Land and Building		138.00
		214.50

(8) Value of Inventories as per Trial Balance

Value of Inventories as per Trial Balance	36.00
Less: Value of slow moving items	3.00
	33.00
Add: NRV of slow moving items	1.20
	34.20

Preparation of Statement of Changes in Equity

As per the requirement of Section 2(40) of the Companies Act, 2013, financial statements include a Statement of Changes in Equity. It is a reconciliation statement showing the changes in the different components of the equity such as :

(1) Share Capital;
(2) Securities Premium;
(3) Revaluation Reserve;
(4) Accumulated Profit; and
(5) General Reserve.etc.

No format has been given till now, in the Companies Act, 2013. However, it may be prepared as follows :

Statement of Changes in Equity **[in ₹]**

	Share Capital	Securities Premium	Accumulated Profit	General Reserve	Revaluation Reserve	Total
Balance from previous period	***	***	***	***	***	***
Changes in Accounting Policy			(***)			(***)
Restated Balance	***	***	***	***	***	***
Surplus in Revaluation of Assets					***	***
Deficit in Revaluation of Assets					(***)	(***)
Net Profit for the Period			***			***
Dividend Paid			(***)			(***)
Issue of Shares	***	***				***
Buy-back of Shares	(***)					(***)
Balance at the End of the Period	***	***	***	***	***	***

Illustration 31

The following trial balance relates to Diamond Enterprise Ltd. :

Particulars	Debit ₹	Credit ₹
Land — at Cost	10,000	—
Building — at Cost	40,000	—
Plant and Machinery — at Cost	1,00,000	—
Furniture and Fixtures — at Cost	4,700	—
Accumulated Depreciation — Building	—	9,000
Accumulated Depreciation — Plant and Machinery	—	43,500
Accumulated Depreciation — Furniture and Fixtures	—	700
Equity Share Capital (10,000 shares of ₹ 10 each)	—	1,00,000
6% Debentures (Secured)	—	25,000
Retained Earnings	—	19,700
Revenue from Operations	—	2,29,000
Other Income	—	1,400
Finance Cost	2,200	—
Salaries to Staff	20,000	—
Electricity	10,000	—
Sundry Expenses	6,000	—
Cost of Sales	1,51,300	—
Inventories on 31.3.2017	35,800	—
Trade Receivables	48,500	—
Trade Payables	—	15,000
Outstanding Liabilities	—	11,700
Cash and Cash Equivalents	36,500	—
Suspense Account (Note 1)	—	10,000
TOTAL	4,65,000	4,65,000

Additional information :

(1) The company sold one of its products on 1st April,. 2016 at ₹ 10,000. The Company has agreed to provide after-sales service for a period of 4 years, i.e., 31st March, 2020 without any extra charge. The estimated cost of servicing is ₹ 300 p.a. which is included in the sale price. The company chages 25% gross profit margin on the servicing. The accountant of the company is confused as to the accounting treatment of this transaction. Therefore he has recorded ₹ 10,000 as suspense.

(2) The debentures were issued on 1st April, 2016 and issue cost of ₹ 1,000 have been charged to salary to staff account.

(3) land has been revalued by the company during the year and an independent professional valuer has valued the land at ₹ 12,000. The resultant gain has not been recorded in the above Trial Balance.

(4) Depreciation to be charged as follows :
(i) Building @ 2%;
(ii) Plant and machinery @ 15%; and
(iii) Furniture and fixtures @ 10%.
All depreciation to be charged on written-down value basis. The depreciation for the year has not yet been recorded in the above Trial Balance.

(5) Current tax expense is to be recorded @ 35% of taxable profit. The tax consultant of the company has calculated current year's taxable profits at ₹ 40,000.

You are required to prepare the following financial statements for the year ending on 31st March, 2017 :
(a) Statement of Profit and Loss;
(b) Statement of Changes in Equity; and
(c) Balance Sheet

Solution

Diamond Enterprise Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹)
I. Revenue from Operations	(1)	2,37,800
II. Other Income		1,400
III. Total Revenue (I + II)		2,39,200
IV. **Expenses :**		
Cost of Sales		1,51,300
Employee Benefits Expenses (₹ 20,000 – 1,000)		19,000
Finance Costs		2,200
Depreciation and Amortization Expenses	(2)	9,495
Other Expenses	(3)	16,000
Total Expenses		1,97,995
V. Profit before Exceptional and Extraordinary Items and Tax (III – IV)		41,205
VI. Exceptional Items		—
VII. Profit before Extraordinary Items and Tax (V – VI)		41,205
VIII. Extraordinary Items		—
IX. Profit before Tax (VII – VIII)		41,205
X. Tax Expense		
(1) Current Tax (35% of ₹ 40,000)		14,000
XI. Profit (Loss) for the period (XI – X)		27,205

Diamond Enterprise Ltd.
Statement of Changes in Equity for the year ended on 31st March, 2017

	Share Capital	Revaluation Reserve	Retained Earnings	Total Equity
Balance on 1.4.2016	1,00,000	—	19,700	1,19,700
Revaluation Reserve	—	2,000	—	2,000
Expenses on Issue of Debenture	—	—	(1,000)	(1,000)
Current Year's Profit	—	—	27,205	27,205
Balance as at 31st March, 2017	1,00,000	2,000	45,905	1,47,905

Balance Sheet of Diamond Enterprise Ltd. as at 31st March, 2017

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(4)	1,00,000
(b) Reserves and Surplus	(5)	47,905
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6% Debentures (Secured)		25,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities	(1b)	800
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		15,000
(b) Trade Payables		12,100
(c) Other Current Liabilities		14,000
TOTAL		2,14,805
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	94,005
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		35,800
(c) Trade Receivables		48,500
(d) Cash and Cash Equivalents		36,500
TOTAL		2,14,805

Working Notes :

(1) Calculation of Revenue to be Recognised in the current year

		₹
Revenue as per Trial balance		2,29,000
Add: Sale of goods to customer (suspense)	10,000	
Less: After-sales service + margin to be recognised as deferred revenue		
$(300 \times 3 \text{ (remaining years)} \times \frac{100}{75})$	1,200	8,800
		2,37,800

(a) Deferred Revenue to be recorded in current liability = ₹ 1,200 / 3 = ₹ 400.

(b) Deferred Revenue to be recorded in long-term liability = ₹ 1,200 / 3 × 2 = ₹ 800.

(2) Calculation of Depreciation

(a) Building :	
2% of (40,000 – 9,000)	620
(b) Plant and Machinery :	
15% of (1,00,000 – 43,500)	8,475
(c) Furniture and Fixtures :	
10% (4,700 – 700)	400
	9,495

(3) Other Expenses

Electricity	10,000
Sundry Expenses	6,000
	16,000

(4) Share Capital

Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 10 each fully paid-up	1,00,000

(5) Reserve and Surplus		
(i) Retrained Earnings	19,700	
Add: Current profit	27,205	
	46,905	
Less: Debentures issue expenses	1,000	45,905
Revaluation Reserve (Land)		2,000
		47,905
(6) Fixed Assets		
(a) *Tangible*		
(i) Building — Cost	40,000	
Less: Accumulated Depreciation (9,000 + 620)	9,620	30,380
(ii) Plant and Machinery — Cost	1,00,000	
Less: Accumulated Depreciation (43,500 + 8,475)	51,975	48,025
(iii) Furniture and Fixtrues — Cost	4,700	
Less: Accumulated Depreciation (700 + 400)	1,100	3,600
		82,005
(iv) Land at Valuation		12,000
		94,005
(7) Other Current Liabilities		
(i) Deferred Revenue		400
(ii) Outstanding Liabilities		11,700
		12,100

Illustration 32

The accountant of Gee Ltd. has prepared the following Trial Balance as at 31st March, 2017 :

Particulars	₹	₹
Land and Building at Cost on 1.4.2016	86,00,000	—
Plant and Machinery at Cost on 1.4.2016	1,66,00,000	—
Accumulated Depreciation :		
Building (1.4.2016)	—	4,00,000
Plant and machinery (1.4.2016)	—	44,40,000
Inventories (1.4.2016)	38,00,000	—
Purchases	4,30,40,000	—
Sales	—	5,39,00,000
Salaries	50,80,000	—
Electricity	6,20,000	—
Sundry Expenses	22,60,000	—
Trade Receivables	35,80,000	—
Trade Payables	—	39,00,000
Cash and Cash Equivalents	25,20,000	—
Interest on Debentures	2,00,000	—
Equity Share Capital of ₹ 10 each (fully paid)	—	70,00,000
7% Preference Shares of ₹ 10 each (fully paid)	—	20,00,000
Retained Earnings (1.4.2016)	—	48,40,000
General Reserve	—	34,20,000
10% Debentures of ₹ 100 each (Secured)	—	40,00,000
Preference Dividend	1,40,000	—
Equity Dividend (Interim)	1,60,000	—
Suspense Account	—	27,00,000
	8,66,00,000	8,66,00,000

Additional information :

(1) Inventory as at 31st March, 2017 was valued at cost ₹ 44,00,000.

(2) Sundry Expenses include ₹ 1,80,000 paid in respect of insurance for the year ending on 1st December, 2017.

(3) Electricity does not include a bill of ₹ 60,000 for three months ending 31st March, 2017, which was paid in April 2017.

(4) The Suspense Account details are as follows :

Proceeds from the issue of 1,00,000 equity shares of ₹ 10 each	24,00,000
Proceeds from sale of plant	60,00,000
	84,00,000
Less: Consideration for acquisition of Tee Ltd.	57,00,000
	27,00,000

(5) The net assets of Tee Ltd. were purchased on 4th May, 2016. Assets were valued as follows :

Investments	46,20,000
Inventories	6,80,000
	53,00,000

All the inventories acquired from Tee Ltd. was sold during 2016-17. However, the investments were still held by Gee Ltd. on 31st March, 2017.

(6) Depreciation on plant and machinery is to be charged for 2016-17 — ₹ 7,20,000.

(7) The plant which was sold had original cost of ₹ 70,00,000 and had a net book value on 1.4.2017 ₹ 54,80,000.

(8) The debentures were issued in the year 2014-15. All equity shares are qualified for dividend.

(9) The land and building was acquired some years back. The building element of the cost was estimated at ₹ 20,00,000 and the estimated useful life of the assets was 50 years at the time of purchase. As at 31st march, 2017, the property is to be revalued at ₹ 1,60,00,000.

(10) The company was incorporated with authorised capital of ₹ 1,00,00,000 divided into 8,00,000 equity shares of ₹ 10 each and 2,00,000, 7% preference shares of ₹ 10 each.

(11) The management wish to provide for :
(i) Interest on debenture due
(ii) Audit fees ₹ 80,000
(iii) Taxation ₹ 6,60,000.

(12) Corporate Dividend Tax is payable @ 20%.

You are required to prepare :

(a) Statement of Profit and Loss for the year ended 31st March, 2017.

(b) Balance Sheet of the same period.

(c) The Statement of Changes in Equity

Solution

Gee Ltd.

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹ in '000)
I. Revenue from Operations		5,39,00
II. Other Income		5,20
III. Total Revenue (I + II)		5,44,20
IV. **Expenses :**		
Purchase of Stock-in-trade	(1)	4,37,20
Changes in Inventories of Finished Goods, W.I.P. and Stock-in-trade	(2)	(6,00)
Employee Benefits Expenses	(3)	50,80
Finance Costs	(4)	4,00
Depreciation and Amortization Expenses	(5)	7,60
Other Expenses	(12)	29,00
Total Expenses		522,60
V. Profit before Exceptional and Extraordinary Items and Tax (III – IV)		21,60
VI. Exceptional Items		—
VII. Profit before Extraordinary Items and Tax (V – VI)		—
VIII. Extraordinary Items		—
IX. Profit before Tax (VII – VIII)		21,60
X. Tax Expense		
(1) Current Tax		6,60
XI. Profit (Loss) for the period (XI – X)		15,00

Balance Sheet of Gee Ltd. as at 31st March, 2017

Particulars	Note No.	Figures for the current reporting period (₹ in '000)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(12)	1,00,00,000
(b) Reserves and Surplus	(13)	1,86,40,000
(c) Money Received against Share Warrants		
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures (Secured)		40,00,000
(4) Current Liabilities :		
(a) Trade Payables		39,00,000
(b) Other Current Liabilities	(14)	4,00,000
(c) Short-term Provisions	(15)	6,60,000
TOTAL		3,76,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(16)	2,19,60,000
(ii) Intangible Assets		4,00,000
(2) Current Assets :		
(a) Inventories		46,20,000
(b) Trade Receivables		44,00,000
(c) Cash and Cash Equivalents		35,80,000
(d) Short-term Loans and Advances		25,20,000
(c) Other Current Assets	(17)	1,20,000
TOTAL		3,76,00,000

Working Notes :

(1) Purchase of Stock in Trade

	₹
Purchases as per Trial Balance	4,30,40,000
Add: Inventories acquired from Tee Ltd.	6,80,000
	4,37,20,000

(2) Changes in Inventories

Opening Inventory	38,00,000
Closing Inventory	44,00,000
Increase in Inventory	(6,00,000)

(3) Employee Benefits Expenses

Salaries	50,80,000

(4) Finance Cost

Interest on Debentures Paid	2,00,000
Add: Outstanding Debentures Interest	2,00,000
Total Interest on Debentures (10% of ₹ 40,00,000)	4,00,000

(5) Depreciation and Amortisation

(i) on Plant and Machinery	7,20,000
(ii) on Building $\left(\frac{20,00,000}{50}\right)$	40,000
	7,60,000

(6) Other Expenses

(i) Sundry Expenses		22,60,000	
Less: Prepaid Insurance		1,20,000	21,40,000
(ii) Electricity		6,20,000	
Add: Outstanding		60,000	6,80,000
(iii) Audit fees (Outstanding)			80,000
			29,00,000

(7) Profit on Disposal of Plant and Machinery

Proceeds from sale of plant (Suspense Account)	60,00,000
Less: Book Value on the date of sale	54,80,000
Profit on Disposal	5,20,000

(8) Revaluation Reserve

Book Value of land and building (at cost)	86,00,000
Less: Accumulated Depreciation	4,00,000
	82,00,000
Less: Depreciation of 2016-17	40,000
Book Value at End of 2016-17	81,60,000
Revalued figure	1,60,00,000
Less: Book Value	81,60,000
Revaluation Gain	78,40,000

(9) Accumulated Depreciation on Plant and Machinery

Opening balance	44,40,000
Depreciation charged during 2016-17	7,20,000
	51,60,000
Less: Accumulated Depreciation of disposed machinery (70,00,000 – 54,80,000)	15,20,000
	36,40,000

(10) Goodwill on Acquisition of Tee Ltd.

Consideration Paid (Suspense)	57,00,000
Less: Assets takenover	53,00,000
	4,00,000

(11) Calculation of Securities Premium

Proceeds of Issue of 1,00,000 shares of ₹ 10 each	24,00,000
Less: Face value of 1,00,000 shares	10,00,000
	14,00,000

(12) Share Capital

Authorised Capital :	
10,00,000 Equity Shares of ₹ 10 each	1,00,00,000
Issued, Subscribed and Paid-up Capital	
8,00,000 Equity Shares of ₹ 10 each fully paid-up	80,00,000
2,00,000, 7% Preference Shares of ₹ 10 each fully paid-up	20,00,000
	1,00,00,000

(13) Reserve and Surplus

(i) General Reserve			34,20,000
(ii) Retained earnings :			
As per Balance Sheet	48,40,000		
Add: Profit for the year	15,00,000	63,40,000	
Less: Appropriations :			
Preference Dividend	1,40,000		
Equity Dividend (Interim)	1,60,000		
	3,00,000		
Corporate Dividend Tax @ 20% on ₹ 3,00,000	60,000	3,60,000	59,80,000
(iii) Revaluation Reserve (Note 8)			78,40,000
(ii) Securities Premium			14,00,000
			1,86,49,000

(14) Other Current Liabilities

Outstanding Debentures Interest	2,00,000
Outstanding Electricity Bill	60,000
Corporate Dividend Tax	60,000
Outstanding Audit Fees	80,000
	4,00,000

(15) Short-term Provisions		
Provision for Taxation		6,60,000
(16) Fixed Assets		
(i) Tangible Assets		
(a) Land and Building (at Valuation)		1,60,00,000
(b) Plant and Machinery	1,66,00,000	
Less: Disposal of Plant	70,00,000	
	96,00,000	
Less: Accumulated Depreciation (Note 9)	36,40,000	59,60,000
		2,19,60,000
(ii) Intangible Assets		
Goodwill (Note 10)		4,00,000
(17) Other Current Assets		
Prepaid Insurance Premium		1,20,000

(iii) Statement of Changes in Equity for the year ended on 31st March, 2017 ('000)

	Share Capital	Securities Premium	Revaluation Reserve	General Reserve	Retained Earnings	Total
Balance on 1.4.2016	90,00	—	—	34,20	48,40	17,260
Retained Earnings	—	—	—	—	15,00	15,00
Securities Premium	—	14,00	—	—	—	14,00
Revaluation Reserve	—	—	78,40	—	—	78,40
Dividend Paid	—	—	—	—	(3,00)	(300)
Corporate Dividend Tax	—	—	—	—	(48)	(48)
Issue of Shares	10,00	—	—	—	—	10,00
Balance on 31.3.2017	100,00	14,00	78,40	34,20	59,92	2,86,52

Special Problems

Illustration 33

The directors of P Ltd., a fashion wholeseller, are reviewing the company's draft financial statements for the year ended 31st March, 2017, which show a profit of ₹ 90,00,000 before tax.

The following matters require consideration :

(i) The closing inventory includes :

(a) 3,000 shirts at cost of ₹ 4,00,000. Since the Balance Sheet date they have all been sold for ₹ 6,50,000, with selling expenses of ₹ 30,000.

(b) 2,000 jackets at cost of ₹ 6,00,000. Since Balance Sheet date half of the jackets have been sold for ₹ 2,50,000 (selling expenses ₹ 18,000) and the remainder are expected to sell for ₹ 2,00,000 with selling expenses of ₹ 20,000.

(ii) An employee dismissed in January 2017 began an action for damages for wrongful dismissal in April 2017. He is claiming ₹ 10,00,000 as damages. P Ltd. is defending the claim and the company's lawyer has advised that the employee has a 30% chance of success in his claim. The financial statements currently include a provision for ₹ 10,00,000 claim.

(iii) In April, 2017 a fire destroyed part of the company's warehouse, with an uninsured loss of inventory worth ₹ 18,00,000 and damaged the building, also uninsured of ₹ 22,80,000. The going concern status of the company is not affected. The financial statements currently make no mention of the fire losses.

Required :

Explain to the directors how these matter should be treated in the financial statements for the year ended 31st March, 2017, stating the relevant accounting standard.

Solution

(i) According to AS—2 Inventories should be valued at the lower of cost and net realisable value (NRV) :

Shirts :

Cost ₹ 4,00,000

NRV ₹ 6,20,000 (₹ 6,50,000 – ₹ 30,000)

The 3,000 shirts should therefore be **included at cost of ₹ 4,00,000**.

Jackets :

Cost ₹ 6,00,000

NRV:

(i) ₹ 2,50,000 less ₹ 18,000	2,32,000
(ii) ₹ 2,00,000 less ₹ 20,000	1,80,000
	4,12,000

The 2,000 jackets should therefore be **included at NRV of ₹ 4,12,000**.

(ii) AS—29 'Provisions, Contingent Liabilities and Contingent Assets', requires contingent liabilities of this kind and degree of probability be disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. **₹ 10,00,000 should therefore be removed and proper note should be given. However, provisions should be made for legal expenses to be incurred**.

(iii) AS—4 'Events after Balance Sheet Date' classified this as a non-adjusting event but a note giving details of the event and its financial effect (a loss of ₹ 18,00,000 plus ₹ 22,80,000 = ₹ 40,80,000) is required as the item is material enough to influence a reader of the financial statements.

Illustration 34

Auto Centre Ltd purchase, restore and sells vintage motorcycles. On 31st March, 2017 they had three motorcycles in inventory. The etails of these are as follows :

Model : Royal Enfield

This motorcycle was purchased for ₹ 48,000 and ₹ 7,500 had been spent for repairing. The company has not yet sold that motorcycle but is confident to sell at ₹ 75,000 at least in May 2017 during 'Motorcycle Mela' at Delhi. It will cost ₹ 4,000 to transport the motorcycle to the event.

Model : Honda

This motorcycle was purchased for ₹ 68,000. At the time of purchase it was estimated that repairs would cost ₹ 11,000. By 31st March, 2016 ₹ 18,000 was spent on repairs and it was sold in May, 2017 at ₹ 80,000.

Model : Harley-Davidson

This motorcycle was purchased for ₹ 85,000. It was estimated that ₹ 12,000 will be required for repairing. the expected selling price is ₹ 1,15,000.

You are required to calculate the following values for each motorcycles :

(i) Cost

(ii) Net Realisable Value; and

(iii) Inventory Value.

Solution **Calculation of Cost, NRV and Inventory Value**

Cost	₹	Net Realisable Value (NRV)	₹	Inventory Value (₹)
1. Royal Enfield				
Purchase Price	48,000	Expected Selling Price	75,000	
Add: Repairs to Complete	7,500	Less: Cost of Selling	4,000	
Cost on 31st March, 2016	55,500	NRV	71,000	55,500
2. Honda				
Purchase Price	68,000	Sale Proceeds	80,000	
Add: Repair Cost (Actual)	18,000			
Cost on 31st March, 2016	86,000			80,000
3. Harley-Davidson				
Purchase Price	85,000	Expected Selling Price	1,15,000	
		Less: Repair required	12,000	
			1,03,000	85,000

Illustration 35

M P Jewellers Ltd buys and restores items of exclusive vintage jewellery. At 31st March, 2017 the company had three items in its Inventory. Details of the items are given below (all figures are in ₹) :

Particulars	Necklace	Bracelet	Pendant
Purchase Cost	2,40,000	6,20,000	9,00,000
Expected Selling Price	5,00,000	7,60,000	10,60,000
Restoration Cost to Date	1,20,000	1,00,000	40,000
Further Cost before Sale	40,000	60,000	20,000

Calculate the value of Inventory as per AS—2 : Inventories for the purpose of inclusion in the Financial Statements ending on 31st March, 2017.

Solution

As per AS—2 : Inventories should be valued at cost or Net Realisable Value INRV) whichever is lower. The value of Inventory has been calculated as follows :

Calculation of Cost and Net Realisable Value (NRV) (₹)

Particulars	Necklace	Bracelet	Pendant
Purchase Cost	2,40,000	6,20,000	9,00,000
Restoration Cost to Date	1,20,000	1,00,000	40,000
Cost on 31st March, 2017	3,60,000	7,20,000	9,40,000
Expected Selling Price	5,00,000	7,60,000	10,60,000
Less: Cost before Sale	40,000	60,000	20,000
Net Realisable Value (at 31st March, 2017)	4,60,000	7,00,000	10,40,000
Lower of Cost and NRV Value	3,60,000	7,00,000	9,40,000

The value of Inventory = ₹ 20,00,000 (3,60,000 + 7,00,000 + 9,40,000)

Illustration 36

As a chief accountant of a public limited company you are reviewing the company's draft financial statements for the year to 31st March, 2017. The draft financial statements showing the current assets of ₹ 50,40,000 and current liabilities of ₹ 50,00,000.

You have been asked to give your views in the following matter :

The company's main business is the manufacturing of industrial paints. The company was involved in legal dispute with the pollution control board for the discharge of waste without following proper regulations. Pollution Control Board fined the company for ₹ 1,50,000. The company filed a case in the court against the fine imposed by the PCB. On 3rd March, 2017 the court passed an order and directed the company to pay ₹ 1,50,000 as fine within 90 days from the date of passing the order. The court had given an opportunity to appeal in the High Court within 60 days from the date of the order. As the company has 60 days for appeal against the court order, the fine has not been taken into consideration. It is the view of the legal advisors that appeal in the High Court is not a right decision. The High Court may increase the fine. In addition, the company would be required to pay additional costs. The Board of Directors in their recent meeting have decided not to appeal against the court's order.

You are required to discuss how the legal dispute and fine should be reflected in the financial statements. Also, calculate the revised amount of current assets and liabilities, if any.

Solution

The main issue in this case is the recognition of liability related to legal disputes with PCB.

It is clear that the company violated the regulation and it has been confirmed by the court order. The amount to be paid as fine is certain and it is to be paid within 90 days from the passing of the court's order. Therefore, it should be recognised as liability in the financial statements ending on 31st March 2017 as the liability was established before the end of the accounting period.

The amount of fine is to be shown under '***Other Current Liabilities***' as it is payable within 90 days.

Current Liabilities will be increased by ₹ 1,50,000. The final figure of current liabilities will be : ₹ 50,00,000 + ₹ 1,50,000 = ₹ **51,50,000**. However, there will be no change in the current assets figures.

Illustration 37

As the chief accountant of M H K Ltd., you are reviewing the company's draft financial statements for the year to 31st March, 2017. The draft financial statements showing the operating profit of ₹ 1,26,89,000 and total shareholders funds of ₹ 6,84,42,500.

You have been asked to give your view in the following matters :

1. **Accident in godown** : On 20t March, 2017 there was a fire in the company's godown. Goods csoting ₹ 3,50,000 was destroyed. The company's accountant included this item in the financial statements by creating a debtor for the compensation due from the insurance company for loss of stock.

On 20th May, 2017, the insurance company wrote to M H K Ltd stating that the claim cannot be admitted on the ground that the proper safety mesures were not taken for prevention of fire.

2. **Robbery of cash** : Generally company holds a high cash balance during the 1st week of the month for the payment of salary to the staff. On 1st April, 2017 the premises were burgled and ₹ 1,78,500 in cash was stolen. The company's accountant has included this loss in the financial statements on the basis that the profit for the year to 31st March, 2017 are better than expected and it is better to write off loss against good profits.

3. C**ompensation claimed by customers** : During the year a number of customers complained that products supplied by M H K Limited were defective and they had to incur cost for rectifying them. The customers have formed a pressure group and have demanded ₹ 16,00,000 as compensation.

After investigation the company accepted the defect in the preoduct and offered ₹ 9,50,000 as compensation. The customers were not happy with the amount of compensation and will move to court.

M H K's legal adviser have stated that the court settlement will be ₹ 12,50,000.

As the dispute is going on and court case is unlikely to take place before April 2018, the company's accountant has not included any change in the financial statements.

Required :

(i) Evaluate the accounting treatment of the above three items by the company's accountant;

(ii) Calculate the amount which should be reported for operating profit and shareholders' funds.

Solution (i)

1. Accident in Godown

Goods costing ₹ 3,50,000 was destroyed by fire. The accountant assumed that the insurance claim will be received in full and on that basis he passed the following entries :

(i) Accidental Loss Account	Dr.	₹ 3,50,000	
To Statement of Profit and Loss			₹ 3,50,000
(ii) Insurance Company Account	Dr.	₹ 3,50,000	
To Accidental Loss Account			₹ 3,50,000

After the closing of the books of account, the insurance company disallowed the claim on the ground that proper safety measures were not taken for prevention of fire.

The above loss of ₹ 3,50,000 is relted to current accounting year. The profit of the year will be reduced by ₹ 3,50,000. It is to be shown in the Statement of Profit and Loss under '***Exceptional Items***'.

2. Robbery of Cash :

This loss occurred after Balance Sheet date and therefore it does not relate to 2016-17. The accountant has charged this loss to current year profit. It is not correct and therefore it should be reversed. The profit of the year 2016-17 will be increased by ₹ 1,78,500. If this amount is material, it should be mentioned in the ***Notes to Accounts*** in detail.

3. Compensation :

The company has accepted that the product was defective. The liability for compensation must be recognised in the financial statement of 2016-17 as the events occurred during the year. The main issue is the amount of compensation to be paid to the csutomers. The liability should be recognised at the best available estimate of the amount by legal advisors, i.e,., ₹ **12,50,000**.

Solution (ii)

(ii) Revised Operating Profit		₹
Profit as per draft financial statement		1,26,89,000
Add: Loss due to robbery on 1st April, 2017		1,78,500
		1,28,67,500
Less: Loss of goods by fire	3,50,000	
Less: Provision for compensation to customers	12,50,000	16,00,000
Revised Operating Profit		1,12,67,500
Revised Shareholders Funds		
As per draft financial statement		6,84,42,500
Less: Net reduction operating profit (16,00,000 – 1,78,500)		14,21,500
		6,70,21,000

Illustration 38

Gamon India Ltd. has prepared its draft financial statements for the year ended 31st March, 2017. They showed a profit of ₹ 9,80,000. After they were prepared and before the directors approved them, the following events took place :

(i) As customer commenced an action against the company to recover ₹ 1,20,000 of losses incurred as a result of Gamon's alleged supply of faulty components in February 2017. The company intends to defend the case vigorously. The company's legal advisors consider it has a 70% chance of successfully defending the action. If the customer's action is successful, damages and cost are expected to amount to ₹ 1,80,000. If Gamon successfully defends the action, non-recoverable legal cost of ₹ 30,000 will be incurred.

(ii) A trade customer for whose balance a full specific provision has been made at 31st March, 2017, paid the amount of ₹ 84,000 in full.

Required :

Advise the directors of Gamon India Ltd. as to the correct accounting treatment of these items, giving your reasons.

If you consider that the financial statements require adjustments, draft journal entries with narrations to give effect to the adjustment.

If you consider that a note to the financial statement is required, draft a suitable disclosure note.

Solution

(i) A provision for ₹ 30,000 should be made for legal cost which will be incurred. According to AS— 4 it is an adjusting event, because this is an action relating to a condition which existed at the Balance Sheet date.

Journal Entry :

Profit and Loss Account	Dr.	₹ 30,000	
To Provision for Legal Costs			₹ 30,000

(Being the creation of provision for legal cost for defending a suit for damages by a customer.)

As the outcome of the case is 70% in favour of the company, it should be disclosed by way of note to the Financial Statements.

Disclosure Note

A customer has brought an action against the company claiming damages for alleged supply of faulty components. Your company will vigorously defend the action and expect to succeed. If the company fails to defend the case, damages and costs could amount to ₹ 1,80,000. A provision for ₹ 30,000 has been made to cover legal cost.

(ii) It is an event requiring adjustment and provision for bad debts to be reduced by ₹ 84,000 in the financial statements.

Journal Entry :

Provision for Bad Debts Account	Dr.	₹ 84,000	
To Profit and Loss Account			₹ 84,000

(Being the reduction in the amount of provision for bad debts on receiving the payment after Balance Sheet date.)

Illustration 39

The directors of T M Ltd is due to meet on 31st May, 2017 to approve the company's draft financial statements for the year ending on 31st March, 2017. The draft financial statements disclose a profit for the year of ₹ 47,13,275 total equity of ₹ 1,42,64,785 and a total assets of ₹ 2,07,04,275.

You have been asked as CFO to provide them with guidance on how the two issues given below is to be dealt with in the financial statements of 2016-17.

Issue 1: On 15th April, 2017, one of the old customer, X & Co contacted the company through e-mail with a request for an extended period of trade credit. This request was made because X & Co's main customer had gone into liquidation few days back. X & Co is owed a significant amount by this customer, and unless X & Co arranges a re-financing from the bank, it cannot pay the dues of T M Ltd.

At 31st March, 2017, the amount owed by X & Co was ₹ 1,29,320. This had increased to ₹ 1,56,390 by 15th April, 2017 and this amount remains unpaid.

Issue 2: On 12th March, 2017, T M ltd received a notice from a customer, claiming that he had been injured by an accident due to a fault in the breaking system of the car which he had purchased 6 months back from T M Ltd. The customer was demanding ₹ 25,00,000 in compensation. T M Ltd's engineers have investigated the problem in the breaking system and reported that it was faulty. T M Ltd legal advisor replied to the customer on 5th April, 2017 offering ₹ 10,00,000 as compensation. This offer has been rejected and the customer has filed a case in the court on 17th April, 2017.

T M Ltd's legal advisor have informed that the case is unlikely to be dealt with by the count untill July, 2017 at the earliest. He is confident that the court will agree to a settlement which is not significantly different to the amount offered on 5th April, 2017 although the court is also likely to award costs totally ₹ 6,00,000 against T M Ltd.

Required :

(a) To explain how each of the above issues should be treated in the financial statements, for the year to 31st March, 2017.

(b) To calculate, the total amount of equity and assets which will be reported in the financial statements for the year to 31st March, 2017 after any adjustments which are required in respect of the two issues.

Solution (a)

Issue 1 : In this case, X & Co is suffering from cash crunch because of the financial problem of one of its customers. X & Co is solvent and is looking for bank loan for payment to T M Ltd. There is no indication of any bad debt. Moreover, it would appear that even if the debt is not collected, it is unlikely to have a significant impact on the decision of the investors as the amount is less than 1% of the total assets and less than 3.5% of the profit of the year.

On the basis of the above, it is appropriate to treat this issue as ***normal trade related matter*** and no action is required at this point.

Issue 2 : This is an event occurring after the Balance Sheet. The financial statements have not yet been approved. Therefore, it is an adjusting event. The key issue is to determine the amount of liability to be provided for this. The claim of the customer is ₹ 25,00,000.

According to the legal advisor, the claim can be settled at ₹ 10,00,000 but the court is also likely to award cost totalling ₹ 6,00,000. Therefore, in total ₹ 16,00,000 is provided for in the financial statements. In that case, the profit will be reduced to ₹ 31,13,275 (₹ 47,13,275 – ₹ 16,00,000).

Solution (b)

Total Amount of Equity after Adjustment	₹
Balance of equity	1,42,64,785
Less: Provision for compensation payable to customer	16,00,000
Final Balance of Equity	1,26,64,785

KEY POINTS

- "Financial Statement" in relation to a company, includes—
  (i) a balance sheet as at the end of the financial year;
  (ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
  (iii) cash flow statement for the financial year;
  (iv) a statement of changes in equity, if applicable; and
  (v) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv).
- As per the provision of Section 2(13) "***books of accounts***" includes record maintained in respect of—
  (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
  (ii) all sales and purchases of goods and services of the company;
  (iii) the assets and liabilities of the company; and
  (iv) the items of cost as may be prescribed under Section 148 in the case of a company which belongs to any class of companies specified under that section.
- ***Section 129(1)*** states that :
  The financial statements shall give ***a true and fair view*** of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in ***Schedule III.***
- Every Statement of Profit and Loss and Balance Sheet of the company shall comply with the accounting standards.
- Where compliance with Accounting Standards necessitates any change in the treatment or disclosure, the same should be made and the requirements of the 'Schedule III' stands modified accordingly.
- The Schedule III has been framed as per the existing ***non-converged*** Indian Accounting Standards. It has no connection with the converged Indian Accounting Standards (Ind-AS) or IFRS.
- Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.
- ***Finance lease obligation*** should be divided into two parts — current and non-current. Non-current portion will be shown under this heading.
- ***Deferred payment liabilities*** also to be divided into two parts — current and non-current. Non-current portion will be shown under this heading.
- The operating cycle of an entity is the time between the acquisition of assets for processing and then realisation in cash or cash equivalents.
- ASB (Accounting Standard Board) has defined 'Exceptional Items' as follows :
  "***Material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individual or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give true or fair view***."
  Here main points are :
  (i) Exceptional items falls within the ordinary activities (i.e., normal business activities of the entity).
  (ii) It must be material.
  Examples of exceptional items are :
  (i) Profits or losses on the sale or termination of an operation.
  (ii) Cost of a fundamental reorganisation or restructuring having a material effect on the nature and focus of the reporting entity's operations.
  (iii) Profits or losses on disposal of fixed assets.

KEY POINTS (Cont.........)

- Extraordinary items are those items which arise from abnormal or unusual events lying outside the ordinary range of entity's activities and which are both ***material and expected not to occur frequently or regularly***.
- **Summary of Different Limits Based on Net Profit of the Company** :

Sl.No.	Managerial Personnel	% of Profit (Maximum)
1.	Directors including managing director and whole-time director, and its manager	11%
2.	If there is one managerial personnel, i.e., managing director or whole-time director or manager	5%
3.	If there are more than one managerial personnel, i.e., managing director and whole-time director or whole-time director and manager	10%
4.	Remumneration payable to directors who are neither managing director or whole-time director : (a) If there is a managing director or whole-time director or manager (b) In other cases	 1% 3%

THEORETICAL QUESTIONS

1. What are the legal requirements regarding the preparation of Company Final Accounts?
2. Explain how the net profits of company are calculated for the purpose of computing remuneration to directors, managers, etc.
3. What are the legal provisions in India regarding over-all maximum managerial remuneration?
4. What do you understand by "Divisible Profits"?
5. Write short notes on:
   (i) Interim Dividend;
   (ii) Unclaimed Dividend; and
   (iii) Preference Dividend.
6. The directors of ABC Ltd. are revieweing the company's draft financial statements for the year ended 31st March, 2017. The following material matters are under discussion :
   1. After the Balance Sheet date one of the company's factories was seriously damaged by fire. Insurance only covered part of the loss suffered. The company's going concern status is not affected.
   2. One of the company's buildings was revalued during the year. The directors are uncertain as to how the revaluation surplus should be included in the financial statements. The surplus has been separately disclosed as an item in the draft income statement.
   3. One of the company's directors was dismissed during 2016 for disclosing confidential information to a competitor. ABC Ltd. has started an action against this director, and the company has been advised that it is probably that the substantial damage will be awarded.
   4. ABC Ltd. guaranteed the overdraft of another company in 2016. No disclosure has been made in previous financial statements but events in the latter part of the year ended 31st March, 2017 suggest that it is probable that a liability will fall on ABC Ltd. in 2016.

   Explain how the above matter should be dealt with in the financial statements for the year ended 31st March, 2017.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. The total managerial remuneration payable by a public company to its directors and manager in respect of any financial year shall not exceed
   A 10%
   B 11%
   C 9%.
2. Corporate Dividend Tax is payable if the dividend paid out of :
   A current profit only
   B accumulated profit only
   C current profit or accumulated profit.

3. Corporate Dividend Tax will be treated as :
   A a charge against profit
   B an appropriation of profit
   C none of the above.
4. Every Balance Sheet and Statement of Profit and Loss of a company shall comply with :
   A US GAAP
   B Indian Accounting Standard
   C International Accounting Standard.
5. What is defined by the statement below ?
   'A resource control by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.'
   A a liability
   B an asset
   C an expense
   D income
6. The draft financial statements of P K Ltd for the year ending on 31st March, 2016, represent a profit of ₹ 4,25,000. The following issues have not yet been taken into account :
   (a) On 16th April, 2016 the insurance company informed P K Ltd that the insurance claim for a robbery which had taken place on 15th March, 2016 would be restricted to ₹ 25,000. P K Ltd claimed ₹ 75,000 and included at the time of calculating the above profit.
   (b) On 10th April, 2016, an accident in the godown destroyed inventory valued ₹ 70,000.
   What is the revised profit when these issues are taken into consideration ?
   A ₹ 3,05,000
   B ₹ 3,55,000
   C ₹ 3,75,000
   D ₹ 4,00,000
7. A customer of P Ltd claimed on 25th February, 2016, a fault in a product sold by P Ltd caused damage to its production line. The customer is seeking damages of ₹ 1,60,000. P Ltd has accepted the liability and offered to pay ₹ 1,00,000 to repair the damages. The customer has not accepted it. The customer has filed a case in the consumer court against P Ltd. The legal advisor of P Ltd is of the opinion that the court will accept the claim of the customer of ₹ 1,60,000. Expected date of hearing of the case is in July 2017.
   How should this matter be dealt with in the financial statements of P Ltd for the period ending on 31st March, 2016?
   A as a current liability of ₹ 1,00,000
   B as a non-current liability of ₹ 1,00,000
   C as a current liability of ₹ 1,60,000
   D as a non-current liability of ₹ 1,60,000
8. What is defined by the following statement ?
   "a present obligation … arising from past events, the settlement of which is expected to result in an outflow … of resources."
   A an expense
   B a liability
   C income
   D an asset
9. Which of the following can be recognized as intangible assets in a company's financial statements ?
   (i) internally generated goodwill
   (ii) purchased goodwill
   (iii) reputation
   A (i) only
   B (ii) only
   C (iii) only
   D all three
10. Goodwill may be classified as either internally generated or purchased. How should goodwill be dealt with in financial statements ?
    A only purchased goodwill should be recognized
    B only internally generated goodwill should be recognized
    C both types of goodwill should be recognized
    D neither type of goodwill should be recognised

PRACTICAL QUESTIONS

1. Calculate the managerial remuneration from the following particulars of Zen Ltd. the company has only one Managing Director.

Particulars	₹
Net Profit	20,00,000
Net Profit is calculated after considering the following :	
Depreciation	4,00,000
Preliminary Expenses	1,00,000
Provision for Tax	31,00,000
Director's fees	80,000
Bonus	1,50,000
Profit on Sale of Fixed Assets (original cost ₹ 2,00,000; WDV ₹ 1,10,000)	1,55,000
Provision for Doubtful Debts	90,000
Scientific Research Expenditure (for setting-up new laboratory)	2,00,000
Managing Director's Remuneration Paid	3,00,000

Other information :
Depreciation allowable is ₹ 3,50,000.
Bonus liability as per the Payment of Bonus Act, 1965 is ₹ 1,80,000.
Looking at the past records of debtors, provision for doubtful debts is not required.
Rate of managerial remuneration is 5%.

2. The following particulars are extracted from the Statement of Profit and Loss of S.S. Ltd. for the year ended 31st March, 2016 :

S.No.	Particulars	₹
(i)	Gross Profit	40,00,000
(ii)	Profit on Sale of Machinery (cost ₹ 8,00,000 and written down value ₹ 4,00,000)	4,50,000
(iii)	Subsidy from the Government	1,00,000
(iv)	Salaries and Wages	1,50,000
(v)	Repairs to Fixed Assets	50,000
(vi)	General Expenses	40,000
(vii)	Compensation for Breach of Contract	25,000
(viii)	Depreciation	2,40,000
(ix)	Loss on Sale of Investment	35,000
(x)	Expenditure on Scientific Research (cost of setting-up a new laboratory)	2,50,000
(xi)	Debenture Interest	75,000
(xii)	Interest on Unsecured Loans	15,000
(xiii)	Provisions for Income Tax	16,00,000
(xiv)	Proposed Dividends	10,00,000
(xv)	net Profit	10,70,000

Calculate the overall managerial remuneration under Section 197 of the Companies Act, 2013.

3. Following is the Profit and Loss Account of Azad Ltd. for the year ended 31st March, 2017 :

Dr. Cr.

Particulars	₹	Particulars	₹
To Office and Administrative Expenses	3,10,000	By Balance b/d	3,43,200
To Selling and Distribution Expenses	1,92,000	By Gross Profit b/d	24,15,000
To Directors' Fees	39,500	By Subsidies	1,39,300
To Managerial Remuneration	1,70,000	By Interest on Investment	9,500
To Interest on Debentures	18,500	By Transfer Fees	1,000
To Donation to Charitable Trust	15,000	By Profit on Sale of Machinery (WDV ₹ 30,000)	25,000
To Compensation for Breach of Contract	27,000		
To Depreciation on Fixed Assets	3,12,000		
To Investment Revaluation Reserve	12,500		
To Provision for Taxation	7,40,000		
To General Reserve	2,50,000		
To Balance c/d	8,46,500		
	29,33,000		29,33,000

Additional information :
Original cost of the Machinery sold was ₹ 40,000.
Depreciation on fixed assets as per Schedule II of the Companies Act, 2013 was ₹ 3,42,000.
You are required to calculate managerial remuneration in the following situations :
(i) when there is only one whole-time director;
(ii) when there are two whole-time directors; and
(iii) when there are two whole-time directors, a managing director and a part-time director.

4. The Manager of M/s. Slow and Steady Ltd. is entitled to get a salary of ₹ 2,500 per month plus 1% commission on the net profits of the company after such salary and commission. The following is the Profit and Loss Account of the company for the year ended 30th June, 2017.

Particulars	₹	Particulars	₹
To Salaries wages and bonus	1,92,500	By Profit b/d	9,00,000
To General expenses	74,000	By Subsidy from Government	60,000
To Depreciation	81,000	By Profit on sale of assets (Cost Price ₹ 2,50,000	
To Expenditure on sceintific research (cost of apparatus)	14,000	and W.D.V. ₹ 1,80,000)	1,00,000
To Manager's salary	30,000		
To Commission to Manager on accounts	6,000		
To Reserve for Bad and doubtful debts	17,500		
To Provision for Income tax	2,40,000		
To Proposed dividend	1,00,000		
To Balance c/d	3,05,000		
	10,60,000		10,60,000

Calculate the remuneration payable to the manager.

5. From the following information of Hindustan Construction Company Limited, you are required to prepare a Statement of Profit and Loss for the year ended on 31st March, 2017 :

Heads of Account	₹
Gross Sales / Revenue from Operations	85,88,905
Purchase of Stock-in-trade	2,05,712
Sub-contractor Charges	16,91,410
Consumption of raw materials, components and stores	3,14,888
Construction materials consumed	17,95,792
Increase in inventories and finished goods and W.I.P.	52,734
Depreciation, amortisation and impairment	4,68,054
Travelling expenses	44,582
Selling and advertisement expenses	40,000
Electricity and fuel cost	60,000
Other income	98,191
Finance cost	3,14,144
Salaries and wages	6,50,000
Contribution to P.F. and Gratuity	64,028
Operating Expenses	13,84,406
Excise Duty	76,064
Provision for Current Tax	2,50,164

6. Alfa Ltd commenced its manufacturing business on 1st April 2016. You have been asked to advise the Managing Director on the valuation of closing inventory on 31st March, 2017.
You have the following information :
(i) Inventory consists of raw materials and finished goods.
(ii) It is the policy of the company to value raw materials using 'periodic weighted average' method.
(iii) The store manager has attempted to value inventory at cost and has calculated the following values :

(a) Raw materials	9,25,750
Finished goods	79,950
Total	10,05,700

(iv) The valuation were carried out as follows :

The price of the raw materials has risen from ₹ 76.25 per unit to ₹ 80.50 per unit during the year. The closing value in point (iii) (a) above represents 11.500 units @ ₹ 80.50 per unit.

There were 195 units of finished goods in inventory at 31st March, 2016, which have been valued at ₹ 410 per unit. The break-up of cost is as follows :

Direct cost	236.25
Factory overhead	113.75
Selling and distirbution overhead	60.00
	410.00

(v) During the year, three batches of raw materials were purchased on the following dates :

30 May	15,000 units @ ₹ 76.25
25 August	13,000 units @ 78.25
20 March	8,000 units @ ₹ 80.50

(vi) 50 units of finished goods were damaged due to collapse of ceiling of the stores room. The repairing cost per unit will be ₹ 130. After repairing these items could be sold @ ₹ 275 per unit.

Required :

(a) Explain with reasons why the stores manager approach is incorrect in valuing the inventory; and

(b) Calculate the correct value of Closing Inventory based on AS—2 : Inventories.

7. The following is the Trial Balance of Bee Ltd as on 31st March, 2017 :

Debits	₹	Credits	₹
Stock as on 1.4.2016	75,000	Purchase Returns	10,000
Purchases	2,45,000	Sales	3,40,000
Wages	30,000	Discount	3,000
Carriage on goods purchased	950	Profit and Loss Account	15,000
Furniture	17,000	Share Capital (10,000 equity shares of ₹ 10 each)	1,00,000
Salaries	7,500	Trade Creditors	17,500
Rent	4,000	General Reserve	15,500
Sundry Trade Expenses	7,050	Bills Payable	7,000
Dividend Paid	9,000		
Trade Debtors	27,500		
Plant and Machinery	29,000		
Cash at Bank	46,200		
Patents	4,800		
Bills Receivable	5,000		
	5,08,000		5,08,000

Prepare a Statement Profit and Loss for the year ended 31st March, 2017 and a Balance Sheet as on that date after considering the following adjustments :

(i) Stock as on 31st March, 2017 : ₹ 88,000.

(ii) Provide for income tax at 50%.

(iii) Depreciate plant and machinery at 15%; furniture at 10%; and patents at 5%.

(iv) On 31st March, 2017 outstanding rent amounted to ₹ 800 and salaries ₹ 900.

(v) The Board recommends payment of a dividend @ 15% per annum. Transfer the minimum required amount to General Reserve.

(vi) Provide ₹ 510 for doubtful debts.

(vii) Provide for managerial remuneration at 10% on profit before tax. ***[C.S. (Inter) — Adapted]***

8. Following is the Trial Balance of X Ltd as on 31st March, 2017 :

Particulars	Dr. (₹)	Cr. (₹)
Share Capital 25,00,000 Equity Shares of ₹ 10 each		2,50,00,000
Profit and Loss Account (1.4.2016)		20,00,000
Stock-in-Trade	35,00,000	
Long-term Loans		17,50,000
Long-term Investments	50,00,000	
Accumulated Depreciation (1.4.2016) on Furnitures, Fixtures, Equipments, etc.		65,00,000
Furniture, Fixtures and Equipments (at cost)	1,70,00,000	
Purchase of Equipments	30,00,000	
Sale of Products (Net of excise duty)		6,25,00,000
Other Income from Operations		1,25,00,000
Trade Debtors	1,75,00,000	

Bills Receivables	20,00,000	
Trade Creditors		18,75,000
Bills Payable		1,25,000
Purchase of Goods for resale	4,22,50,000	
Carriage on goods purchased	5,00,000	
Salaries and Wages	80,00,000	
P.F. and Gratuity Contribution	15,00,000	
Rent, Rates and Taxes	12,50,000	
Electricity and Fuel	6,25,000	
Travelling and Conveyance	6,25,000	
Loss by Fire	15,00,000	
Sale Proceeds of Furniture		2,50,000
Cash in Hand	7,00,000	
Cash at Bank	50,00,000	
Advertisement Expenses	12,50,000	
Selling and Distribution Expenses	13,00,000	
TOTAL	11,25,00,000	11,25,00,000

Additional information :

(1) Net Realisable Value of closing stock is ₹ 55,00,000. However, it is estimated that the cost of closing stock is ₹ 50,00,000.

(2) It is the policy of the company to charge full year's depreciation for purchase of any asset. However, no depreciation is charged on disposed assets. The rate of deprecition is 20% p.a. on cost on all assets.

(3) During the year 2016-17, The company purchased equipments for ₹ 30,00,000.

(4) Some furniture were sold during the year for ₹ 2,50,000. The original cost was ₹ 15,00,000. Accumulated depreciation is ₹ 7,50,000.

(5) No claim was paid by the Insurance company for loss on fire as the policy was defective.

(6) Proposed dividend is 20% on equity shares.

(7) Corporate dividend tax is 20%.

(8) Rate of Income-tax is 35%.

You are required to prepare :

(i) a Statement of Profit and Loss for the year ended on 31st March, 2017;

(ii) a Balance Sheet as on that date.

9. Anonymous Limited closes its books on 31st March every year. A newly appointed assistant drew up the following Trial Balance as on 31.3.2017 :

Particulars	Dr.	Cr.	Particulars	Dr.	Cr.
Sh. Capital: (4 lac eq.sh. of ₹ 10 each)		40,00,000	Calls-in-arrears	12,000	
Purchases	40,00,000		Sales		55,00,000
Stock as on 1st April 2016	7,00,000		Debtors	14,50,000	
Creditors		5,00,000	Provision for doubtful debts		5,000
Bad debts	3,000		Bad debts recovered		200
Fixed assets at cost: Land	17,00,000		Fixed assets at cost: Buildings	25,00,000	
Fixed assets at cost: Furniture	5,00,000		Fixed assets at cost: Motor vehicles	3,10,000	
Accumulated depreciation: Buildings		60,000	Accumulated depreciation: Furniture		1,00,000
Motor vehicles		50,000	Salaries	3,50,000	
Postage and telegram	10,000		Printing and stationery	15,000	
Motor vehicle expenses	45,000		Investments (at cost)	5,00,000	
Interest received		15,000	Directors' fees	14,500	
Auditors' fees	5,000		Profit & Loss A/c (Cr. balance)		2,60,000
13% Debentures		18,00,000			
Cash and Bank balances	1,75,700		TOTAL	1,22,90,200	1,22,90,200

The following information is available further:

(a) The value of stock as on 31.3.2017 is ₹ 10,00,000.

(b) Anonymous Ltd. has appointed an agent during the year and goods were sent out at an invoice price of ₹ 5,00,000 which was determined by adding 25% margin on cost. As on 31.3.2017, the entire stock was still lying with the agent as unsold. The value of the closing stock shown above does not include the stock with the agent.

(c) Depreciation should be provided on written-down values of the assets at the following rates: Buildings 5%; Furniture 10%; and Motor vehicles 20%.

(d) Market value of investments as on 31.3.2017 was ₹ 6,50,000.

(e) Provision for doubtful debts is required to be maintained at ₹ 10,000. A provision for discounts on debtors is to be created at 0.5% of debtors.

(f) The debentures had been issued on 1st October, 2016. Interest is payable semi-annually on 31st March and 30th September.

(g) Provision for income tax to be created at ₹ 4,50,000.

(h) The directors propose a dividend of 10% on capital.

You are required to prepare:

(i) Statement of Profit and Loss for the year ended 31st March, 2017; and

(ii) Balance Sheet as on 31st March, 2017.

10. The authorised capital of Moon Ltd. is ₹ 5,00,000 consisting of 2,000, 6% Preference Shares of ₹ 100 each and 30,000 Equity Shares of ₹ 10 each. The following was the Trial Balance of Moon Ltd. as on 31st March, 2017 :

Debit Balances	₹	Credit Balances	₹
Investment in Shares at cost	50,000	Sundry Creditors	87,850
Purchases	4,90,500	6% Preference Share Capital	2,00,000
Selling Expenses	79,100	Equity Share Capital fully paid-up	2,00,000
Stock on 1st April, 2016	1,45,200	5% Mortgage Debentures secured on freehold	
Salaries and Wages	52,000	properties	1,50,000
Cash in Hand	12,000	Dividends	4,250
Interim Preference Dividend for the half-year ended		Profit and Loss Account (1st april, 2016)	28,500
30th September, 2016	6,000	Sales (Net)	6,70,350
Discount on Issue of Debentures	2,000	Bank Overdraft secured by hypothecation of	
Preliminary Expenses	1,000	stocks and receivables	1,50,000
Bills Receivable	41,500		
Interest on Bank Overdraft	7,800		
Interest on Debentures upto 30th September, 2016	3,750		
Sundry Debtors	50,100		
Freehold Property at cost	3,50,000		
Furniture at cost less depreciation of ₹ 15,000	35,000		
Income-tax Paid in advance for 2016-17	10,000		
Technical know-how fees at cost, paid during the year	1,50,000		
Audit Fees	5,000		
	14,90,950		14,90,950

You are required to prepare Statement of Profit and Loss for the year ended 31st March, 2017 and the Balance Sheet as on that date after taking into account the following :

(i) Closing stock was valued at ₹ 1,42,500.

(ii) Purchases include ₹ 5,000 worth of goods and articles distributed among valued customers.

(iii) Salaries and wages include ₹ 2,000 being wages incurred for installation of electrical fittings which were recorded under furniture.

(iv) Bills receivable include ₹ 1,500 being dishonoured bills, 50% of which had been considered irrecoverable.

(v) Bills receivable of ₹ 2,000 maturing after 31st March, 2017 were discounted.

(vi) Depreciation on furniture to be charged @ 10% on written down value.

(vii) Discount on issue of debentures to be written off fully.

(viii) Interest on debentures for the half year ended on 31st March, 2017 was due on that date.

(ix) Provide provision for taxation ₹ 4,000.

(x) Technical knowwhow fees is to be written off over a period of 10 years.

(xi) Preliminary expenses are to be written off fully.

(xii) Salaries and wages include ₹ 10,000 being directors' remuneration.

(xiii) Sundry debtors include ₹ 6,000 debts due for more than 6 months.

(xiv) Rate of corporate dividend tax is 17%.

Keeping in mind the requirements of Part I and Part II of Schedule III of the Companies Act, 2013, prepare Statement of Profit and Loss for the year ended 31st March, 2017 and Balance Sheet as on that date of Moon Ltd as close thereto as possible. Figures for the previous year can be ignored.

[***Note:*** EPS not to be calculated]

11. The following balances have been extracted from the books of Pioneer Traders Ltd. as on 31st March, 2017 :

Particulars	₹	₹
Share Capital (Authorised and Issued) :		
Equity (15,00,000) Shares of ₹ 100 each	—	1,50,000
8% Redeemable Preference (40,000 Shares)	—	4,000
Securities Premium	—	2,500
Preference Share Redemption	4,800	—
General Reserve	—	10,000
Land (cost)	30,000	—
Buildings (cost less depreciation)	70,000	—
Furniture (cost less depreciation)	2,000	—
Motor Vehicle (cost less depreciation)	3,500	—
Gross Profit	—	90,000
Establishment Charges	25,000	—
Rate, Taxes and Insurance	1,200	—
Commission	600	—
Discount Received	—	500
Interest on Investments	—	800
Depreciation	6,000	—
Sundry Office Expenses	6,000	—
Payment to Auditors	400	—
Sundry Debtors and Creditors	10,660	2,560
Profit and Loss Account (as on 1.4.2016)	—	1,000
Unpaid Dividend	—	200
Cash in Hand	1,200	—
Cash at Bank in Current Account	19,500	—
Security Deposit	1,000	—
Outstanding Expenses	—	600
Investments in G.P. Notes	20,000	—
Stock in trade (at or below cost)	35,300	—
Provision for Taxation (year ended 31.3.2016)	—	7,000
Income-tax Paid under Dispute (year ended 31.3.2016)	10,000	—
Advance Payment of Income Tax	22,000	—
	2,69,160	2,69,160

The following further details are available :

(i) The preference shares were redeemed on 1st April, 2016 at a premium of 20% but no entries were passed for giving effect thereto, expect payment standing to the debit of preference share redemption account.

(ii) Depreciation as provided upto 31.3.2017 is as follows :
(a) Building ₹ 21,000; (b) Furniture ₹ 200; Motor Vehicles ₹ 6,000.

(iii) Establishment charges include ₹ 1,800 paid to managing director as remuneration in terms of agreement which provides for a remuneration of 5% of annual net profits.

(iv) Payment to auditors includes ₹ 100 for taxation work in addition to audit fees.

(v) Market value of investments on 31st March, 2017 is ₹ 18,000.

(vi) Sundry Debtors include ₹ 4,000 due for a period exceeding six months.

(vii) All receivables and deposits are considered good for realisation.

(viii) Income tax demand for the year ended 31st March, 2017 ₹ 10,000 has not been provided for against which appeal is pending.

(ix) Income tax is to be provided @ 34%.

(x) Directors recommended payment of dividend on equity shares at the rate of 12%.

(xi) Ignore previous year's figures.

You are required to prepare the Statement of Profit and Loss for the year ended 31st March, 2017 and a Balance Sheet as at that date.

Guide to Answers

Multiple Choice

1. B; **2.** C; **3.** B; **4.** B; **5.** B; **6.** C; **7.** D; **8.** B; **9.** B; **10.** A.

Practical Questions

1. (i) Profit as per Section 198 of the Companies Act, 2013 = ₹ 57,45,000.
   (ii) Managerial remuneration as per Section 197 — ₹ 2,87,250 (5% of ₹ 57,45,000).
2. (i) Profit for managerial remuneration as per Section 198 — ₹ 39,05,000.
   (ii) Maximum overall managerial remuneration — ₹ 4,29,550 (11% of ₹ 39,05,000).
3. (i) When there is only one whole-time director : 5% of ₹ 16,45,800 — ₹ 82,290.
   (ii) When there are two whole-time directors : 10% of ₹ 16,45,800 — ₹ 1,64,580.
   (iii) When there are two whole-time directors and a part-time director : 11% of ₹ 16,45,800 — ₹ 1,81,038.
4. Profits for managerial remuneration ₹ 6,82,500; commission ₹ 6,400; salary and commission must be restricted to ₹ 32,500 (5/105 × 6,82,500).
5. Profit before tax ₹ 7,12,773.
   Profit after tax ₹ 4,62,609.
   Revenue from operation ₹ 85,12,840
6. Value of Closing Stock as per As-2 : Inventories

		₹
(i) Raw materials : 11,500 units @ ₹ 79.9166		8,96,042
(ii)Finished goods :		
195- 50 units ₹ 350	50,750	
50 units @ ₹ 145 (NRV)*	7,250	58,000
Total		9,54,042

Finished goods to be valued at cost of production : (236.25 + 113.75) = ₹ 350.00
Selling and distribution overhead should not be taken into consideration.
*NRV of damaged goods = ₹ 275 - 130 = ₹ 145.

7. (i) Profit before tax ₹ 56,648; (ii) Profit after tax ₹ 28,326. EPS = ₹ 2.83; and (iii) Balance Sheet total ₹ 2,10,700.

Working Notes : **(1) Calculation of Profits for the purpose of Managerial Remuneration**	₹
Profits before tax and managerial remuneration	63,000
Add: Provision for Doubtful Debts (being discount allowed)	510
	63,510
∴ Managerial remuneration = 10% of ₹ 63,510 = ₹ 6,351.	

(2) Dividend of ₹ 9,000 appearing in the Trial Balance is treated as interim dividend. The Board recommends payment of dividend @ 15% p.a. It means that interim dividend is also a part of 15% dividend per annum. Therefore ₹ 6,000 (₹ 15,000 – ₹ 9,000) is to be provided as **Proposed Dividend**.

(3) Where proposed dividend exceeds 12.5% but does not exceed 15% of the paid-up capital, the amount to be transferred to Reserve should not be less than 5% of the current profit. Therefore, amount to be transferred to Reserve = 5% of ₹ 28,325 = **₹ 1,416**.

(4) Corporate Dividend Tax is payable on ₹ 15,000 (₹ 9,000 paid + ₹ 6,000 proposed) @ 16% = ₹ **2,400.**

8. (i) Profit before exceptional, extraordinary and tax ₹ 1,50,00,000.
   (ii) Loss by fire will be treated as an exceptional item.
   (iii) Profit before extraordinary and tax ₹ 1,35,00,000.
   (iv) Profit before tax ₹ 1,35,00,000.
   (iv) Profit after tax ₹ 87,85,000.
   (v) Balanec Sheet total ₹ 4,42,50,000.
9. (i) Profit before tax ₹ 14,29,500.
   (ii) Profit after tax ₹ 9,79,500. EPS = ₹ 2.45.
   (iii) Balance Sheet total ₹ 80,94,500.

Calculation of Depreciation	Building @ 5%	Furniture @ 10%	Motor Vehicles @ 20%
Original cost (₹)	25,00,000	5,00,000	3,10,000
Less: Accumulated depreciation	60,000	1,00,000	50,000
Written-down value	24,40,000	4,00,000	2,60,000
Depreciation	1,22,000	40,000	52,000

10. (i) Profit before tax : ₹ 3,550. (ii) Profit after tax : ₹ (450).
    (iii) Balance Sheet total ₹ 8,23,650.
11. (i) Profit before tax ₹ 51,205; (ii) Net profit after tax ₹ 33,795; (iii) Provision for taxation ₹ 17,410;
    (iv) Balance Sheet total ₹ 2,25,160.

Appendix – 1
XBRL
The Future Language of Business and Financial Reporting

Introduction

For last couple of years, XBRL has been the 'Buzz' word in the accounting parlance. We have been curious to know what XBRL is and exactly what the taxonomy is. More important questions that arise in mind are how exactly is it going to affect us accountants and how far reaching would be its implications in the Indian Accounting System.

What is XBRL?

The full form of XBRL is eXtensible Business Reporting Language. XBRL is a standard, a specification that defines a new way of a new language for creating, storing, communicating and comparing business reporting information.

Here, 'Business reporting includes, but is not limited to, financial statements, financial information, non-financial information and regulatory filings such as annual and quarterly financial statements'.

XBRL reportedly has revolutionised the business reporting around the globe. It has proved beneficial in preparation, analysis and communication of business information. Its major benefits are cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data. It is already being used in a number of countries and implementations of XBRL are growing rapidly around the world. In the United States, the XBRL taxonomy has been developed for US GAAP and UK has developed the same for IFRS.

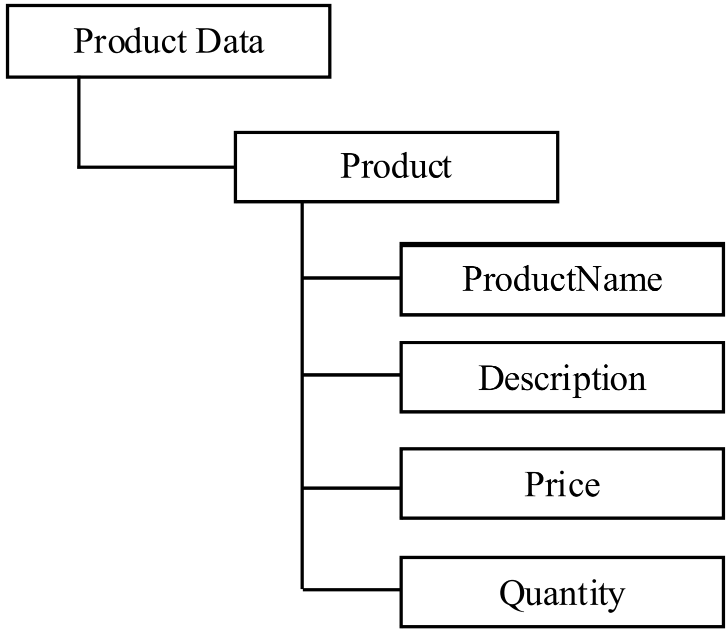
In India, IRIS had developed the draft taxonomy in the year 2006, which had been published as an exposure draft by the ICAI that was open for comments till October 28, 2008. After that Ministry of Corporate Affairs in collaboration with the ICAI has published the final taxonomy for IND-AS, based on the exposure draft and the comments received thereon.

XBRL provides a standard format for preparing business reports that can subsequently be presented in a variety of ways. This standard format is XML-based and allows information to be exchanged between different software applications. It allows automated, efficient and reliable extraction of information by software applications and facilitates automated comparison of financial and other business information, notes to financial statements between companies, and also comparing various items, which would otherwise be performed manually.

XBRL is XML Based

XBRL documents are basically XML documents. XML or eXtensible Markup Language is a text-based markup language that enables you to store data in a structured format by using meaningful tags. The term "eXtensible" implies that you can extend your ability to describe a document by defining meaningful tags for your application.

XML is a markup language. To create XML documents, you have to define your own tags. Let us take up a hypothetical case of a small database which stores product data. The business deals with two types of products - books and periodicals. Each product should have a product identification number, category, price and quantity in store. The hierarchical order of this information is shown in the following page.



The XML file storing information about the products may look like:

```
<?xml version="1.0" encoding="ISO-8859-1"?>
<ProductData>
     <Product ProductID="P001" Category="BOOKS">
      <ProductName> Finacial Accounting </ProductName>
<Description> This book is based on undergraduate syllabus </Description>
     <Price currency = "Indian Rupees"> 350 </Price>
       <Quantity> 20 </Quantity>
</Product>
```

Thus, XML is self-descriptive and designed to structure, store and carry data, not display data.

For a hand on experience, you can type the above XML document in Notepad and save it as products.xml.

Remember all XML files have .xml extension. Since XBRL data files are XML files, they also have .xml extension.

If you open the products.xml file in Internet Explorer, you will see a web page like display:

```
<?xml version "1.0 encoding="ISO-8859-1"?>
<ProductData>
   <Product Category="BOOKS" ProductID="P001">
       <ProductName> Financial Accounting </ProductName>
       <Description> This book is based on undergraduate syllabus </Description>
       <Price> ~ 350 </Price?
       <Quantity> 20 </Quantity>
   </Product>
</ProductData>
```

The document is providing details about one particular product of type "BOOKS". Each element in the information hierarchy has been tagged or marked up.

XBRL is a Subset of XML

XBRL inherits from XML. It is a subset of XML. The difference between XML and XBRL could be compared to that between an English language dictionary and a dictionary for business terms.

XBRL also like XML associates nonprintable characters and words with data:

```
<Price currency = "Indian Rupees"> 350 </Price>
```

XML is a cross-platform, hardware and software independent markup language. For example, users of both Macintosh and Windows operating systems can access XML data from their respective platform. So is XBRL; it has backing from Microsoft, IBM, Adobe, Sun Microsystems and all other industry leaders.

XML documents can be easily interpreted by the target systems by using software called parser that checks the syntax used in XML files.

XML data is stored in plain text format and XML documents are platform independent. It means you can create an XML file using Notepad. This makes it much easier to create data that different applications can share. In turn, a business unit can have transactions with any other business unit irrespective of their data storage system. It simplifies not only data storage, data transport as well. With XML, data can easily be exchanged between incompatible systems.

Let us now look at a few terms that would help you understand an XML document structure and in turn, an XBRL document.

Some XML Terms

Tags are used for specifying a name for a given piece of information. It is a means of identifying data. Data is marked-up using tags. A tag consists of an opening and a closing angular bracket (< >). These brackets enclose the name of the tag. Tags usually occur in pairs - each pair consists of a start tag and an end tag. The start tag contains the name of the tag while the end tag includes a forward slash (/) before the name of the tag.

```
<ProductName> Finacial Accounting </Product Name>
```

In the above example, <ProductName> is a new tag used for storing the name of the products in the bookstore.

Elements are the basic units that are used to identify and describe the data in XML. They are the building blocks of an XML document. Elements are represented using tags. You can provide your own meaningful tags or use some predefined ones.

In case of XBRL the tags are mostly predefined. However, you can extend the XBRL documents by creating your own elements.

The information represented by the elements of an XML documents is referred to as the content of that element. In our example,

```
<ProductName> Financial Accounting </Product Name>
```

The name of the product - Financial Accounting - is the content of the <Product Name> element.

Attributes provide additional information about the elements for which they are declared. An attribute consists of a name-value pair. Consider the line from our example:

```
<Product ProductID="P001" Category="BOOKS">
```

The element Product has two attributes - ProductID and Category. The value of the ProductID attribute is P001 and the value of the Category attribute is BOOKS. Elements can have one or more attributes. Attributes or attribute values can be either mandatory or optional.

An XML ***Schema*** defines the structure of the content of an XML document, thereby allowing you to store data in a consistent format. It specifies: the elements, the attributes, data types of the elements, arrangement of the elements and whether an element is optional or mandatory.

Let us go back to the tag structure from our previous example:

```
<?xml version="1.0" encoding="ISO-8859-1"?>
<ProductData>
    <Product ProductID="P001" Category="BOOKS">
    <ProductName> Finacial Accounting </ProductName>
<Description> This book is based on undergraduate syllabus </Description>
    <Price> ~ 350 </Price>
    <Quantity> 20 </Quantity>
</Product>
</ProductData>
```

A probable schema for the above document, could be:

```
<xsd:element name="ProductName" type="xsd:string" />
<xsd:element name="Description" type="xsd:string" />
<xsd:element name="Price" type="xsd:positiveInteger" />
<xsd:element name="Quantity" type="xsd:nonNegativeInteger" />
```

You need not understand the details of such coding but you can see that a schema is just another document declaring the elements, the attributes, data types of the elements, arrangement of the elements and whether an element is optional or mandatory.

Now Over to XBRL

After going through the above discussion, it would be easier to understand the XBRL standard now.

XBRL is application of XML technology to business and financial reporting. XBRL data files are basically XML documents. The XBRL framework splits business reporting information into two components:

- XBRL Instances
- XBRL Taxonomies

The XBRL ***instances*** are the actual XML data files with a root element <xbrl> and the XBRL ***taxonomies*** are the schema files that define the concepts being communicated by the data in the instance document. The combination of an XBRL instance and its supporting taxonomies, and additional link bases constitute an XBRL business report.

The skeleton of an XBRL instance document should look like:

```
<xbrl>
      <schemaRef>
            <linkbaseRef>
            …
            </linkbaseRef>
      </schemaRef>
…
…
</xbrl>
```

In case of XML, you may have your own elements and tag your document in a meaningful structure. However, XBRL taxonomies provide a data dictionary that define different industries' mandatory and commonly used reporting concepts. So the elements are predefined here.

Your XBRL document needs to conform to the standard XBRL taxonomy you are using.

Each XBRL taxonomy has tags, labels, definitions and references for tagging the business data meaningfully. However, since no single XML vocabulary can capture the entirety of business reporting, XBRL has therefore included extensibility as a design principle. You can create your own taxonomies.

XBRL Taxonomy

Taxonomies are schema files that contain the element definitions for tagging data for reporting purposes according to the rules of US GAAP, IFRS, IND-AS and other generally accepted accounting principles. Organizations can create new taxonomies to describe organization-specific information included within common market taxonomies. That is why it is called extensible.

In XBRL taxonomy, definition of a reporting term is called 'concept', it is similar to the element definition in XML schema. A concept is given a concrete name and a type.

The ICAI website defines XBRL taxonomy as:

XBRL Taxonomy is a classification system that can be considered as an electronic dictionary for business and financial terms. It consists of a delineation of all the business and financial concepts along with their basic accounting and XBRL properties as well as the interrelationships amongst the concepts. It should be noted that taxonomy does not contain any factual financial information that is reported by the entities, it contains only the concepts.

XBRL taxonomy consists of the ***schema*** and ***linkbases***. Schema is the set of all the concepts with attributes and documentation. The *linkbases* are basically hyperlinks in the taxonomy document that provides links with other taxonomies or documents thus establishing the relationship amongst the various concepts.

The *linkbases* document the meaning of the concepts by expressing relationships between concepts and by relating concepts to their documentation. A linkbase is a collection of extended links. There are five different kinds of extended links used to document concepts: definition, calculation, presentation, label and reference. The first three types of extended link express inter-concept relationships, and the last two express relationships between concept and their documentation.

The *linkbases* may be stored in a separate document from the taxonomy schema or embedded in the taxonomy schema. The <linkbaseRef> tag in the taxonomy schema points to the linkbase document, when it is not part of the taxonomy.

The XBRL taxonomies technically are XSD schema files with .xsd extension.

XBRL Instance

The XBRL instances could be compared with the actual XML data files; they contain the actual values of facts based on the defined concepts. An XBRL instance can be supported by one or more taxonomy. These taxonomies can be interconnected, extending and modifying each other in various ways. Generally, it is necessary to consider multiple related taxonomies together for interpreting an XBRL instance.

The set of related taxonomies is called a Discoverable Taxonomy Set (DTS). A DTS is a collection of taxonomy schemas and linkbases.

Ministry of Corporate Affairs (MCA) website defines the XBRL instance document as:

An XBRL instance document is a business report in an electronic format created according to the rules of XBRL. It contains facts that are defined by the elements in the taxonomy it refers to, together with their values and an explanation of the context in which they are placed. XBRL Instances contain the reported data with their values and "contexts". Instance document must be linked to at least one taxonomy, which defines the contexts, labels or references.

The actual data contained in an XBRL instance document is called 'fact'. Each fact corresponds to a concept defined in the supporting DTS. Facts could be simple or compound. The simple facts are expressed as simple contents. The simple contents are generally referred as 'items'. The compound facts are expressed are made up from other simple and/or compound facts. The compound facts are expressed using 'tuples'. Syntax for any given tuple or item is defined in the taxonomy schema.

The instance document contains the values of the 'facts' that correspond to the concepts included in the taxonomy. The facts can either be numeric (monetary, shares or other numeric information) or non-numeric (string, date or text block). The following table will help to understand the difference between the terms 'concept' and 'fact'.

Concept	Fact
Company Name	M. H. K. Ltd.
Current Assets	400000000
Net Profit	5000000
Earnings Per Share	5
Date of AGM	2016-08-09

Each XBRL instance document starts with a root element <xbrl>. The <schemaRef> and <linkbaseRef> tags in the XBRL instance provides the link to the taxonomy schemas and linkbases supporting the instance document.

The XBRL instances are technically XML files with .xml extension.

The Advantage Points

Most endearing advantage of using XBRL in business reporting lies in the fact that the information in the reports can be made instantly searchable and retrievable. Since XBRL data files are simple text files, overheads for uploading these files to your website or your personal computer or even to your mobile device are negligible. They are backed up by XML technologies, so carry all the advantages of XML. These documents are stored in plain text format and platform independent. This makes it much easier to create data that different applications can share. In turn, a business unit can have transactions with any other business unit irrespective of their data storage system. It simplifies not only data storage, data transport as well. With XML, data can easily be exchanged between incompatible systems.

However unlike XML, XBRL vocabulary is established by standards committee. Using these vocabulary, business transactions and operations can be referred and represented in a standard way.

XBRL documents can be accessed by operations, printed for an annual report, accessed by various agencies, imported into other database or published on the web. In each case, the user gets a view suitable to his or her needs in terms of content, granularity and formatting.

XBRL brings immense improvement in communicating data. Prior to XBRL, when one company shared data with another company, the receiving company needed to have the same software to recognize the data and its meaning. XBRL makes that unnecessary because the fact or data is sent along with its meta-data describing what it means. In fact, it creates an 'universal data language' for the global market. Software like Microsoft Excel or Access can be used to access an XBRL document.

XBRL data can be relied upon to be more accurate, because most business applications can access and retrieve XBRL data automatically, which ensures availability of real-time, up-to-date information in a much faster way. XBRL data can be shared or distributed efficiently without regards to systems and platforms. This improves exchange of data internally across departments, divisions and subsidiaries. Analysts often had faced problems while re-keying data from financial reports to their spread sheets. XBRL eliminates such problems. XBRL has in true sense, automated the process of data collection and reports are produced at minimal effort. It removes all time-consuming, error-prone processes as well as performs accuracy checks on software.

XBRL meta data (read taxonomy) to business is often compared to the barcodes to the retailers. Barcodes were devised for ensuring that the item price were entered correctly at the billing counters and thus speed up sale and enhance the shopping experience all together. However, soon other advantages were found out - the codes made it possible to track sales and update inventory. It helped in recognizing the most popular product and whether these products are in store. These days, barcodes are put on items right when they are packaged. The retail chain companies can track items down the supply chain - from manufacturing to the sales counter effortlessly and accurately.

Conclusion

The ICAI XBRL taxonomy has been constructed to conform to the Indian Accounting Standards and Company Law while adapting the architectural features of the IFRS XBRL taxonomy 2006. This taxonomy considers three broad reporting categories:

- Commercial and Industrial
- Banking Companies
- Non-Banking Finance Companies

The current version of ICAI XBRL taxonomy is a general purpose taxonomy, designed for Commercial and Industrial group (C&I), which would include trading entities, oil and gas companies, service providing entities, real estate and construction companies and all other commercially operated entities.

The ICAI taxonomy has been designed for:

- Balance Sheet
- Statement of Profit and Loss
- Cash Flow Statement

We would like to conclude here; with the hope that this section will help young would be accountants to become XBRL enthusiasts. For detailed description of the Indian taxonomy, please visit:

http://mca.gov.in/XBRL/Vision.html

http://www.icai.org/icai_xbrl/Launch.html

For any query, students can contact us at pmhanif@gmail.com

9

Valuation of Goodwill and Shares

Goodwill

Goodwill may be described as the aggregate of those intangible attributes of a business which contribute to its ***superior earning capacity*** over a normal return on investment. It may arise from such attributes of a business as good reception, a favourable location, the ability and skill of its employees and management, nature of its products, trust of the customers, etc.

From a different angle, goodwill may be viewed as a more or less permanent impression created in the minds of the customers of a particular organisation who continue to patronise that organisation despite the high price of its product which enables the organisation to earn super-profits. ***For example***, 'Apple' mobile phones. So, goodwill is the outcome of an impression created in the mind of each customer.

Lord Lindley defines goodwill as follows :

"The term goodwill can hardly be said to have any precise significance. It is generally used to denote the benefit arising from connection and reputation and its value is what can be got for the change of being able to keep that connection and improve it. Upon the sale of an established business its goodwill has a marketable value, whether the business is that of a professional man or of any other person. But it is plain that goodwill has no meaning except in connection with a continuing business, and the value of the goodwill of any business to a purchaser depends in some cases entirely, and in all very much, on the absence of competition on the part of those by whom the business has been previously carried on".

According to Wilson,

"Goodwill has been very ably divided into three types — cat, dog and rat — in view of the peculiar habits of these three animals. The cat tends to stick to the abode, cat goodwill is therefore that which will adhere to the business which is being transferred and is the most valuable. The dog follows his master, dog goodwill is difficult to transfer and is correspondingly less valuable. The rat is a migrant, rat goodwill is practically valuless, as it represents those customers who have no specialities either to the business or its properties and who may be here today and gone tomorrow. Summed up, cat goodwill is adherent; dog personal and rat fugitive. Adherent goodwill is only valuable as attaching to the business; personal goodwill is unsaleable, fugitive goodwill is only valuable in that as one fugitive goes another may arrive."

Following are other definitions :

"Goodwill is nothing more than the probability that the old customers will resort to the old place" (Lord Eldon).

"The value of business connections, the value of the probability that present customers will continue to buy in spite of the allurements of competing dealers" (Hatfield).

"The element of an established business which makes the business as a going concern worth more than its book value, that is, its net worth as shown by the books" (Walton).

"It is the influence that the proprietor or his organisation has upon the purchasing public through which he is enabled to attract and retain patronage" (Wildman).

Distinguishing Features of Goodwill

Goodwill is different from any other type of assets since it is the ***earning power*** of the business. Following are the factors distinguishing goodwill from most other assets :

(a) It represents a non-physical value over and above the physical assets.
(b) It cannot have an existence separate from the business and, therefore, cannot be realised separately.
(c) It is difficult to place a cost on goodwill as the value may fluctuate from day-to-day as a result of internal and external circumstances, i.e., changing fortunes of the company's business.
(d) The amount or value of the goodwill and the assessment of its actual existence is highly dependent on the subjective judgment of the valuer.

Elements of Goodwill

R.H. Nelson suggests that goodwill generally consists of the following elements :

(a) Customer lists;
(b) Organisation costs;
(c) Developmental costs;
(d) Trademarks, trade names and brands;
(e) Secret processes and formulae;
(f) Patents;
(g) Copyrights;
(h) Licenses;
(i) Franchises; and
(j) Superior earning power.

Types of Goodwill

Goodwill is generally of two types: (a) Purchased Goodwill; and (b) Non-purchased or Inherent Goodwill.

(a) Purchased Goodwill

Purchased Goodwill arises when one business buys another and the purchase consideration paid is more than the value of the net tangible assets received. It can never exist in a new business except by purchase.

It is the accepted practice to recognise only the purchased goodwill in the accounting system. Therefore, goodwill should enter into the books of account of a business only in connection with a valuation ascribed to it in the acquisition price of a business.

Following are the important features of purchased goodwill:

(i) It arises on an acquisiton.
(ii) It is demonstrated by a purchase transaction.
(iii) Price paid for goodwill depends upon the purchaser's expectation of future profits.
(iv) It is recognised in financial statements.

(b) Non-purchased or Inherent Goodwill

Non-purchased or inherent goodwill is referred to as internally generated goodwill and it arises when a business may over the years generate its own goodwill.

Following are the features of non-purchased goodwill :

(i) It is internally generated.
(ii) A cost cannot be placed on these types of goodwill.
(iii) Valuation depends on subjective judgment of the valuer.
(iv) It is not demonstrated by a purchase consideration.
(v) It is never recognised in financial statements.

Factors to be taken into consideration in valuing goodwill:

Non-purchased and purchased goodwill		Purchased goodwill only	
1.	Superior management team.	1.	Market dominance.
2.	Outstanding sales manager or organisation.	2.	Economies of scale (production, advertising, distribution, research, management)
3.	Weakness in the management of a competitor.	3.	Cost savings (employing technology, transaction costs, co-ordinating activities, stockholding savings).
4.	Effective advertising.	4.	Cost of financing (reduction in cost of borrowing and lender's risk).
5.	Secret or patented manufacturing process.	5.	Fiscal advantages (tax losses, investment credits, government incentives).
6.	Good labour relations.	6.	Strong liquid resources.
7.	Outstanding credit rating.	7.	Preliminary expense savings.
8.	Top flight training programme for employees.	8.	Ability to guarantee supplies.
9.	Good public "image".	9.	Ability to guarantee market.
10.	Unfavourable developments in operation of a competitor.	10.	Investors' collective evaluation of political, economic or social position.
11.	Favourable association with another company.	11.	Opinions of acquirer's directors as to future policy of acquirer.
12.	Strategic location.	12.	Costs of acquisiton.
13.	Discovery of talents or resources.		
14.	Favourable tax conditions.		
15.	Favourable government regulations.		
16.	Favourable attitudes of customers.		
17.	Excellent reputation of quality and reliability of products.		
18.	Number of outlets for products.		
19.	Number of service locations for products.		
20.	Favourable agency agreements.		
21.	Established list of customers.		
22.	Established licence to trade.		
23.	Experienced work-force.		
24.	Good relations with suppliers.		
25.	Superior pension fund resources.		

Source: ASC discussion paper — Appendix 2

Positive and Negative Goodwill

Since goodwill is the difference between the value of a business as a whole and the fair value of its separate net assets, goodwill can be both positive and negative.

Non-purchased goodwill exists in all businesses. Positive goodwill arises when the value of the business as a whole is more than the fair value of the separate net assets. If the real worth of the business is less than the sum of the fair values of the separate net assets, it represents negative goodwill.

Accounting for Goodwill

Following are the methods of accounting for goodwill:

(a) Carry it as an asset and write it off over a period of years through the Profit and Loss Account.
(b) Eliminate it against reserves immediately.
(c) Retain it as an asset with no write-off unless a permanent reduction in value becomes evident.
(d) Write it off against profits immediately.
(e) Show it as a deduction from shareholders' funds which may be amortized or carried forward indefinitely.

In this connection, Para 36 of AS—10 is very important. This para states that 'Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business takenover, the excess should be termed as Goodwill'.

Valuation of Non-purchased Goodwill

Goodwill is a significant asset, but subject to the suspicion of arbitrations since its valuation depends on assumptions made by the valuer. Methods to be adopted in valuing goodwill will depend upon the circumstances of each particular case. Therefore, the figure computed as goodwill cannot be an exact one.

There are several ways by which an accountant can compute goodwill. The valuation of goodwill is often based on the customs of the trade and generally calculated as number of years' purchase of average profits or super profits. Here, we will outline some of the various methods available :

(1) Average Profit Method

This method takes into account the average profits for the last few years and fixes the value of the goodwill as to many years' purchase of this amount. Under this method, at first, averge profit is calculated on the basis of the past few years' profits. At the time of calculating average profit, precaution must be taken in respect of any abnormal items of profit or loss which may affect future profit. It should be mentioned that average profit may be based on ***simple*** average or ***weighted*** average.

After calculating average profit, it is multiplied by a number (3 or 4, i.e., three or four years), as agreed. The product will be the value of the goodwill.

The main disadvantage of this method of valuing goodwill is that any trend in the level of profitability is not reflected in the valuation of goodwill. If the simple average is used, i.e., each year's profits are given the same weightage, no discrimination is made between a business that has rising profits and one that has falling profits. To overcome this, it is necessary to give more weightage to the profits of recent years. If the weighted average profits are taken for the last four years, the last year should be given a weightage of 4, the previous year a weightage of 3, the prior to that a weight of 2 and so on. To obtain the weighted average profit, the profit of the year must be multiplied by its weightage and the grand total should be divided by the aggregate number of weights.

Since goodwill figures rely on a series of estimates and assumptions, different weightings would produce different end results.

The following important points are to be noted in determining the profits upon the basis of which goodwill is to be valued :

- ***(a)*** ***From the total profit, income from investments are to be excluded. This is because, the capital value of these investments are not to be considered while calculating the capital employed. The return from investments are not trading incomes and will not normally be that expected from the use of other assets.***
- ***(b)*** ***The charges for depreciation can cause a change in the amount of net profits. If excessive depreciation is charged, it should be added back. On the other hand, where depreciation charges are inadequate, a further charge should be made. Therefore, the charges for depreciation should be properly reviewed.***
- ***(c)*** ***Income from any assets not generally used in the business should be excluded from profits as also the value of the asset from the capital employed.***
- ***(d)*** ***Abnormal profits and losses, arising from abnormal circumstances, should be eliminated from the profits of the years in which they occured.***
- ***(e)*** ***Excessive remuneration, i.e., above normal or fair remuneration paid to the owners or directors should be written-back by the amount it exceeds over fair remuneration.***
- ***(f)*** ***Abnormal expenditure on advertisements in a particular accounting should be properly adjusted. It should be allocated in such a fashion that each year is charged with the average normal expenditure on advertisement.***

Illustration 1

A Ltd. agreed to purchase business of a sole trader. For that purpose, goodwill is to be valued at 3 year's purchase of the average profits of last 5 years.

Profits for these years are :

2011 — ₹ 40,000; 2012 — ₹ 45,000; 2013 — ₹ 36,000; 2014 — ₹ 46,000; 2015 — ₹ 50,000.

Solution

$$\text{Average Profit} = \frac{40{,}000 + 45{,}000 + 36{,}000 + 46{,}000 + 50{,}000}{5} = ₹\ 2{,}17{,}000 \div 5 = ₹\ 43{,}400.$$

Goodwill = 3 years' purchase of average profit of last 5 years = ₹ 43,400 × 3 = ₹ **1,30,200**.

Illustration 2

X Ltd. proposed to purchase the business carried on by Mr. A. Goodwill for this purpose is agreed to be valued at 3 years' purchase of the weighted average profits of the past four years. The appropriate weights to be used are :
2012 — 1; 2013 — 2; 2014 — 3; 2015 — 4.

Profits for these years are : 2012 — ₹ 20,200; 2013 — ₹ 24,800; 2014 — ₹ 20,000 and 2015— ₹ 30,000.

On a scrutiny of the accounts, the following matters are revealed : (a) On 1st September, 2014 a major repair was made in respect of the plant incurring ₹ 6,000 which amount was charged to revenue. The said sum is agreed to be capitalised for Goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method; (b) The closing stock for the year 2013 was overvalued by ₹ 2,400; and (c) To cover management cost an annual charge of ₹ 4,800 should be made for the purpose of goodwill valuation. You are required to compute the value of goodwill of the firm.

Solution

Before calculating goodwill, it is necessary to compute adjusted profit on the basis of information given.

Calculation of Adjusted Profit

Particulars	2012 (₹)	2013 (₹)	2014 (₹)	2015 (₹)
Profit (as given)	20,200	24,800	20,000	30,000
Less : Management cost	4,800	4,800	4,800	4,800
	15,400	20,000	15,200	25,200
Less: Overvaluation of closing stock	—	2,400	—	—
Add: Overvaluation of opening stock (Note 1)	—	—	2,400	—

	15,400	17,600	17,600	25,200
Add: Capitalisation of repairs	—	—	6,000	—
	15,400	17,600	23,600	25,200
Less: Depreciation (Note 2)	—	—	200	580
	15,400	17,600	23,400	24,620

Calculation of Average Profit

Year	Profit (₹)	Weights	Products (₹)
2012	15,400	1	15,400
2013	17,600	2	35,200
2014	23,400	3	70,200
2015	24,620	4	98,480
		10	2,19,280

Weighted Average Profit = ₹ 2,19,280 / 10 = ₹ 21,928.
Goodwill = 3 years' purchase of weighted average profit = ₹ 21,928 × 3 = ₹ **65,784**.

Note :
(1) Closing stock of 2013 becomes the opening stock of 2014
(2) Depreciation of 2014 = 10% of ₹ 6,000 for 4 months = ₹ 200. 2015 = 10% of (₹ 6,000 – ₹ 200) = ₹ 580.

(2) Super Profit Method

Super profit is the excess of actual profit over the normal profit of an enterprise. A common method of valuation of goodwill is the super-profit method. A business unit may possess some advantages which enable it to make extra profits over and above the amount that would be earned if the capital of the business was invested elsewhere with similar risks. These extra profits, generally expressed as super profits, can be valued, and goodwill is the value of the few years' purchase of super profit.

Under this method, super profits are taken as the basis for calculating goodwill in place of average profit. Like the previous method, this value is also computed by applying a traditional rule acceptable in the trade, e.g., three or four years' purchase of super profit. For calculating goodwill, the following steps are as follows :

Step 1 Calculate capital employed (it is the total of shareholders' equity plus long term debt or fixed assets plus net current assets).

Step 2 Calculate normal return by multiplying capital employed with normal rate of return.

Step 3 Calculate average maintainable profit of the business (after adjustment of abnormal and extra-ordinary items).

Step 4 Calculate the difference between the average maintainable profit and normal return as calculated above. This difference is called ***super profit*** (if it is positive).

Step 5 Multiply that super profit by the number of years' purchase. The product is the value of the goodwill.

Illustration 3

The following particulars are available in respect of the business carried on by Sucharan.

(i) Capital employed — ₹ 50,000.
(ii) Trading profit (after tax) :
2012 — ₹ 12,200; 2013 — ₹ 15,000; 2014 — ₹ 2,000 (Loss); and 2015 — ₹ 21,000.
(iii) Market rate of interest on investment — 8%.
(iv) Rate of risk return on capital invested in business — 2%.
(v) Remuneration from alternative employment of the proprietor (if not engaged in business) ₹ 3,600 p.a.

You are required to compute the value of goodwill on the basis of 3 years purchase of super profits of the business calculated on the average profit of the last four years.

Solution

(1) Calculation of Average Profits

Particulars	₹
2012	12,200
2013	15,000
2014	(2,000)
2015	21,000
	46,200
Average Profits = ₹ 46,200 / 4	11,550

(2) Calculation of Super Profits

Particulars	₹
Average Profits	11,550
Less: Remuneration	3,600
Average Trading Profits	7,950
Less: Normal Profit @ 10% on ₹ 50,000	5,000
Super Profits	2,950

Goodwill = 3 years' purchase of super profits = ₹ 2,950 × 3 = ₹ **8,850**.

Illustration 4

From the following information, calculate value of goodwill taking 5 years' purchase of super profit.

(i) Equity Share Capital : 5,000 Equity Shares of ₹ 20 each fully paid.
(ii) Preference Share Capital : 1,000, 8% Preference Shares of ₹ 100 each fully paid.
(iii) General Reserve : ₹ 30,000.
(iv) Loss on revaluation of Plant and Mchinery : ₹ 12,000.
(v) Average trading profit after tax : ₹ 30,000.
(vi) Normal rate of return on capital employed : 12%.

Solution

(1) Calculation of Capital Employed

Particulars	₹
(I) Equity Share Capital (5,000 X ₹ 20)	1,00,000
(II) Preference Share Capital (1,000 x ₹ 100)	1,00,000
(iii) General Reserve	30,000
	2,30,000
Less: Revaluation Loss of Plant	12,000
Capital Employed	2,18,000

(2) Computation of Avg. Maintainable Trading Profit

Particulars	₹
Average Trading Profit after Tax	30,000
Less: Normal Return on Capital Employed [10% of ₹ 2,18,000]	21,800
Super Profit	8,200

Goodwill = 5 years' purchase of Super Profit = 5 x ₹ 8,200 = ₹ **41,000.**

Illustration 5

From the following information calculate the value of goodwill :

(a) Average capital employed ₹ 12,00,000.
(b) Company declares 15% dividend on the shares of ₹ 20 each fully paid, which is quoted in the market at ₹ 25.
(c) Net trading profit of the firm (after tax) for the past 3 years : ₹ 2,15,200; ₹ 1,81,400; ₹ 2,25,000.

You are required to compute the value of goodwill on the basis of 5 years purchase of super profits of the business calculated on the average profit of the last three years.

Solution

(1) Calculation of Average Profits

Particulars	₹
1st Year	2,15,200
2nd Year	1,81,400
3rd Year	2,25,000
	6,21,600
Average Profits = ₹ 6,21,600 / 3	2,07,200

(2) Calculation of Super Profits

Particulars	₹
Average Trading Profit after Tax	2,07,200
Less: Normal Profit @ 12% on ₹ 12,00,000 (Note 2)	1,44,000
Super Profits	63,200

Goodwill = 5 years' purchase of super profits = ₹ 63,200 × 5 = ₹ **3,16,000.**

Tutorial Notes : In this problem, the rate of return on capital employed has not been given. It is to be calculated as follows :

(1) Dividend per share = 15% of ₹ 20 = ₹ 3.

(2) Rate of return on capital = $\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$ = 3/25 × 100 = 12%.

Illustration 6

Following is the Balance Sheet of Navin Traders as on 31.3.2016:

Liabilities	₹	Assets	₹
Creditors	1,52,160	Fixed Assets	3,60,000
Capital	6,56,000	Current Assets	4,88,160
Reserve	1,60,000	Investments in shares	1,20,000
	9,68,160		9,68,160

The following net profits were earned which included a fixed income on investment of ₹ 8,000 per year.

Year ended 31 March : 2013 ₹ 1,28,000; 2014 : ₹ 1,44,000; 2015 : ₹ 1,72,000; 2016 : ₹ 1,80,000.

Standard rate of return on capital employed in this type of business is 8%.

Calculate the value of goodwill of the above business at three years purchase of the average super profits for the four years assuming (i) that each years profit is immediately withdrawn in full by the proprietor and (ii) the weights to be assigned to the profits for the purpose of averaging are :

Year Enging on 31st March,	:	2013	2014	2015	2016
Weight	:	1	1.5	2	2.5

Ignore Income tax.

Solution **(1) Calculation of Trading Profit**

Year ending on 31st March	2013 (₹)	2014 (₹)	2015 (₹)	2016 (₹)
Profit	1,28,000	1,44,000	1,72,000	1,80,000
Less : Income on Investment	8,000	8,000	8,000	8,000
Trading Profits	1,20,000	1,36,000	1,64,000	1,72,000

(2) Calculation of Weighted Average Profit

Particulars	2013 (₹)	2014 (₹)	2015 (₹)	2016 (₹)	Total (₹)
Trading Profits	1,20,000	1,36,000	1,64,000	1,72,000	5,92,000
Weight	1	1.5	2	2.5	7
Product	1,20,000	2,04,000	3,28,000	4,30,000	10,82,000
Weighted Average Profits = ₹ 10,82,000 / 7 = ₹ 1,54,571					

(3) Calculation of Capital Employed **(4) Calculation of Super Profits**

Particulars	₹	Particulars	₹
Fixed Assets	3,60,000	Weighted Average Profits	1,54,571
Current Assets	4,88,160	Less: Normal Profit @ 8% on ₹ 6,96,000	55,680
	8,48,160	**Super Profits**	98,891
Less : Creditors	1,52,160		
	6,96,000		

Goodwill = 3 years' purchase of super profits = 3 × ₹ 98,891 = ₹ **2,96,673**.

Illustration 7

Negotiation is going on for transfer of X Ltd. on the basis of the Balance Sheet and the additional information as given below :

Balance Sheet of X Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,00,000 Equity Shares of ₹ 10 each fully paid		10,00,000
(b) Reserves and Surplus — Profit and Loss Account		4,00,000
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables —Sundry Creditors		3,00,000
TOTAL		17,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets —		
Land and Building		4,00,000
Plant and machinery		8,00,000
(b) Non-current Investments		1,00,000
(2) Current Assets :		
(a) Inventories		2,00,000
(b) Trade Receivables — Debtors		1,50,000
(c) Cash and Cash Equivalents — Cash at Bank		50,000
TOTAL		17,00,000

Profit before tax for 2015-16 amounted to ₹ 6,00,000 including ₹ 10,000 as interest on investment. However, an additional amount of ₹ 50,000 p.a. shall be required to be spent for smooth running of the business.

Market values of Land and Buildings and Plant and Machinery are estimated at ₹ 9,00,000 and ₹ 10,00,000 respectively. In order to match the above figures further depreciation to the extent of ₹ 40,000 should be taken into consideration.

Income tax rate may be taken at 50%. Return on capital at the rate of 20% before tax be considered normal for this business at the present stage.

For the purpose of determining the rate of return, profit for this year after the aforesaid adjustments may be taken as expected average profit. Similarly, average trading capital employed is also to be considered on the basis of the position in this year. It has been agreed that four years' purchase of super profit shall be taken as the value of goodwill for the purpose of the deal.You are required to calculate the value of goodwill of the company.

Solution

(1) Calculation of Capital Employed

Particulars	₹
Land and Buildings (Market Value)	9,00,000
Plant and Machinery (Market Value)	10,00,000
Inventories	2,00,000
Debtors	1,50,000
Cash and Bank	50,000
	23,00,000
Less: Sundry Creditors	3,00,000
Closing Capital Employed	20,00,000

(2) Computation of Avg. Maintainable Trading Profit

Particulars	₹	₹
Net Profit before Tax		6,00,000
Less: Additional Depreciation (given)	40,000	
Less: Additional recurring expenses (given)	50,000	
Less: Interest on Investment (Non-operating profit)	10,000	1,00,000
		5,00,000
Less: Provision for Tax @ 50%		2,50,000
Profit after Tax		2,50,000

Alternatively, Capital Employed can be calculated as follows :

Particulars		₹
Share Capital		10,00,000
Profit and Loss Account Balance		4,00,000
		14,00,000
Add: Increase in the value of assets :		
Land and Building (9,00,000 – 4,00,000)	5,00,000	
Plant and Machinery (10,00,000 – 8,00,000)	2,00,000	7,00,000
		21,00,000
Less: Non-current Investment		1,00,000
Closing Capital Employed		20,00,000

(3) Calculation of Average Capital Employed

Particulars	₹
Closing capital employed [as per above (1)]	20,00,000
Less: 1/2 of average maintainable trading profit after tax (Note 2)	1,25,000
	18,75,000

(4) Calculation of Super Profits

Particulars	₹
Profit after tax (Trading) — Note 2	2,50,000
Less: 10% of Average Capital employed	1,87,500
Super Profits	62,500

Goodwill = 4 years' purchase of super profit = ₹ 62,500 × 4 = ₹ **2,50,000**.

Tutorial Notes :

(1) For the purpose of computation of capital employed, investment should not be taken into consideration. Similarly, income from such investment should not be included in the average maintainable profit.

(2) Closing capital employed includes current year's profit after tax (i.e., ₹ 2,50,000). Assuming that the profits were earned evenly throughout the year, 1/2 of ₹ 2,50,000 is to be deducted from closing capital to calculate Average Capital Employed. The logic is that the entire profits were not earned on the first day of the accounting period. These were earned evenly and were employed in the business accordingly.

Illustration 8

From the following information, prepare statements showing :

(i) Capital employed;
(ii) Average capital employed;
(iii) Goodwill on the basis of 5 years' purchase of the average super profit :

Balance Sheet of Z Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each		3,00,000
(b) Reserves and Surplus — General Reserve		1,25,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		90,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		60,000
(b) Other Provisions — Provision for Taxation		20,000
TOTAL		5,95,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,50,000
(b) Non-current investments — 6% Government Bond		45,000
(2) Current Assets :		
(a) Other Current Assets		2,00,000
TOTAL		5,95,000

The current market value of the plant included in fixed assets is ₹ 15,000 more.
The average profit of the company (after deductions for interest on debentures and govt. taxes) is ₹ 68,000.
Expected rate of return is 10%; Assume rate of tax is 50%.

Solution

(a) Calculation of (Closing) Capital Employed

Particulars		₹
Tangible Fixed Assets : ₹ (3,50,000 + 15,000)		3,65,000
Other Current Assets		2,00,000
		5,65,000
Less: Liabilities:		
Sundry Creditors	60,000	
Provision for taxation	20,000	80,000
Closing Capital Employed		4,85,000

(b) Average Capital Employed

Particulars	₹
Closing Capital Employed	4,85,000
Less: 1/2 of Adjusted Average Trading Profit after tax (Note 1) (1/2 of ₹ 71,150)	35,575
Average Capital Employed	4,49,425

Alternatively, Capital Employed can be calculated as follows :

Particulars	₹
Equity Share Capital	3,00,000
General Reserve	1,25,000
	4,25,000
Add: Increase in the value of Tangible Assets	15,000
	4,40,000
Less: 6% Government Bond (Tutorial Note 1)	45,000
	3,95,000
Add: 10% Debentures (Tutorial Note 2)	90,000
Closing Capital Employed	4,85,000

(c) Value of Goodwill = 5 years' purchase average super profit = 5 × ₹ 26,207 (Note 2) = ₹ 1,31,035; say — ₹ **1,31,000**.

Working Notes : **(1) Calculation of Adjusted Average Trading Profit after Tax**

Particulars	(₹)
Average Annual Profit after tax	68,000
Less : Interest on investment after tax shield : ₹ (45,000 x 6/100 x 50/100) (Note 3)	1,350
	66,650
Add: Interest on Debenture after tax shield : ₹ (90,000 x 10/100 x 50/100) (Note 3)	4,500
	71,150

(2) Calculation of Average Super Profit

Particulars	(₹)
Adjusted Average Trading Profit after tax	71,150
Less: Normal return on Average capital employed (10% on ₹ 4,49,425)	44,943
Super Profits	26,207

Tutorial Notes :

(1) At the time of calculating capital employed, investment in 6% Government Bond should not be taken into consideration.

(2) Debenture should be treated as a part of ***capital employed***.

(3) For calculating adjusted trading profit, interest on investment (after tax) should be deducted from average annual profit (because, investment has not been considered while calculating capital employed).
Similarly, interest on Debenture (after tax) should be added back to average annual profit.

Illustration 9

The Balance Sheets of ABC Ltd. for 2014 and 2015 disclose the following position :

Balance Sheet of ABC Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)		(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	1,50,000	2,20,000
(b) Reserves and Surplus — General Reserve		80,000	80,000
Profit and Loss		50,000	1,50,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 7% Debentures		60,000	60,000
(4) Current Liabilities :			
(a) Other Current Liabilities		—	—
(b) Trade Payables — Trade Creditors		25,000	30,000
TOTAL		3,65,000	5,40,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Land and Buildings		1,30,000	1,25,000
Plant and Machinery		60,000	85,000
(b) Non-current investments — 10% Government Bonds		40,000	40,000
(2) Current Assets :			
(a) Trade Receivables — Trade Debtors		60,000	50,000
(b) Cash and Cash Equivalents — Cash at bank		75,000	2,40,000
TOTAL		3,65,000	5,40,000

Notes to Accounts :

(1) Share Capital

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	1,00,000	1,50,000
8% Preference Shares of ₹ 10 each fully paid	50,000	70,000
	1,50,000	2,20,000

Calculate the value of Goodwill on the basis of the following additional information :

(a) Last five years' profits are given below which are arrived at before charging interest on Debenture, payment of Preference Dividend after charging depreciation and payment of tax. No dividend on equity shares was paid in those years :
2011—₹ 1,00,000; 2012—₹ 1,20,000; 2013—₹ 1,10,000; 2014—₹ 10,000; 2015—₹ 1,05,000.

(b) Under Voluntary Retirement Scheme the company spent ₹ 95,000 in 2014.

(c) Before 1st January, 2014, the company had no investments. On that date, it invested ₹ 40,000 in 10% Government Bonds at face value. Profits for 2014 and 2015 include interest on Govt. Bonds.

(d) The reasonable return on capital employed is 12%.

(e) The goodwill is to be valued on 3 years' purchase of super profit.

(Assume tax rate is 5%).

Solution **Calculation of Adjusted Profit (After Tax)**

Particulars	2011 (₹)	2012 (₹)	2013 (₹)	2014 (₹)	2015 (₹)
Profits after Tax (as given)	1,00,000	1,20,000	1,10,000	10,000	1,05,000
Add: VRS Expenses (Net of Tax)	—	—	—	47,500	—
Less: Interest on Investments (Net of Tax)	—	—	—	(2,000)	(2,000)
Adjusted Profit after Tax	1,00,000	1,20,000	1,10,000	55,500	1,03,000

$$\text{Average Profit after Tax} = \frac{1,00,000 + 1,20,000 + 1,10,000 + 55,500 + 1,03,000}{5} = ₹\ \mathbf{97,700}$$

Calculation of Capital Employed

Particulars	2014 (₹)	2015 (₹)
Total Assets (excluding Investments)	3,25,000	5,00,000
Less: Trade Creditors	25,000	30,000
Capital Employed	3,00,000	4,70,000

$$\text{Average Capital Employed} = \frac{\text{Opening Capital employed} + \text{Closing Capital Employed}}{2}$$

$$= \frac{3,00,000 + 4,70,000}{2} = \frac{7,70,000}{2} = ₹\ \mathbf{3,85,000}$$

Calculation of Average Super Profit

Particulars	₹
Adjusted Average Trading Profit after Tax	97,700
Less: Normal Return on Average Capital Employed [12% of ₹ 3,85,000]	46,200
Super Profits	51,500

Value of Goodwill = 3 year's purchases of super profits = ₹ 3 × ₹ 51,500 = ₹ **1,54,500**.

(3) Capitalisation of Average Profit Method

Under this method, the business unit is valued by applying the following formula :

$$\text{Total value of the firm} = \frac{\text{Average maintainable profit}}{\text{Normal rate of return}} \times 100$$

After calculating the value of the firm in the above manner, the net assets of the business unit is deducted from this and the balance is the value of the goodwill.

Illustration 10

From the information given below, calculate Goodwill as per capitalisation of average profits method :

(i) Capital employed ₹ 14,00,000
(ii) Normal rate of profit 10%
(iii) Net profits before taxation (tax rate 40%) :
1st year : ₹ 2,20,000; 2nd year : ₹ 2,80,000; 3rd year : ₹ 2,60,000; 4th year : ₹ 3,00,000; 5th year : ₹ 2,75,000.
(iv) Non-trading income of ₹ 10,000 and Debenture interest ₹ 20,000 on an average is included in the Profit and Loss Account.

Solution

Average Profit = ₹ (2,20,000 + 2,80,000 + 2,60,000 + 3,00,000 + 2,75,000) / 5 = ₹ **2,67,000**.

Calculation of Average Maintainable Profit (After Tax)

Particulars	₹
Average Profit (Before Tax)	2,67,000
Add: Debenture Interest	20,000

	2,87,000
Less: Non-Trading Income	10,000
Profit before Tax	2,77,000
Less: Tax @ 40%	1,10,800
Profit after Tax	1,66,200

$$\text{Total Value of the Firm} = \frac{\text{Average Maintainable Profit after Tax}}{\text{Normal Rate of Return}} \times 100$$

$$= \frac{1,66,200}{10} \times 100 = ₹\ \mathbf{16,62,000}$$

Goodwill = Total Value of the Firm – Capital Employed
= ₹ 16,62,000 – ₹ 14,00,000 = ₹ **2,62,000**

Illustration 11

Following is the Balance Sheet of Swan Ltd. as at 31.3.2016 :

Balance Sheet of Swan Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 25,000 Equity Shares of ₹ 10 each fully paid		25,00,000
(b) Reserves and Surplus — Profit and Loss Account		3,50,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		4,80,000
(b) Trade Payables — Sundry Creditora		8,05,000
(c) Short-term Provisions — Provision for Income Tax		4,25,000
TOTAL		45,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets —		
Land and Building at Cost		11,00,000
Plant and Machinery less Depreciation		10,00,000
(2) Current Assets :		
(a) Inventories		15,00,000
(b) Trade Receivables — Book Debts		9,60,000
TOTAL		45,60,000

The company started operation on 1st April, 2011 with a paid-up capital of ₹ 25,00,000 as mentioned above. Profits earned before providing for taxation have been as follows :

Year ending on 31st March :	2012	2013	2014	2015	2016
	₹ 6,00,000	₹ 7,50,000	₹ 8,50,000	₹ 9,50,000	₹ 8,50,000

Rate of income tax is 50%; Normal rate of return is 12%.

You are required to calculate the value of goodwill of Swan Ltd. by adopting capitalisation of average profit method.

Solution

Computation of Net Tangible Assets

Particulars		₹
Tangible Assets :		
Land and Buildings		11,00,000
Plant and Machinery		10,00,000
Inventories		15,00,000
Book debts less provision		9,60,000
	[A]	45,60,000
Liabilities :		
Loan		4,80,000
Sundry Creditors		8,05,000
Provision for Taxation		4,25,000
	[B]	17,10,000
Net Tangible Assets	[A – B]	28,50,000

Computation of Average Maintainable Profit

Particulars	₹
31st March, 2012	6,00,000
31st March, 2013	7,50,000
31st March, 2014	8,50,000
31st March, 2015	9,50,000
31st March, 2016	8,50,000
	40,00,000
Average Profit = ₹ 40,00,000 / 5	8,00,000
Less: Provision for tax : 50%	4,00,000
Profit after Tax	4,00,000

$$\text{Total value of the business} = \frac{\text{Average maintainable profit}}{\text{Normal rate of return}} \times 100 = \frac{4,00,000}{12} \times 100 = ₹\ 33,33,333$$

Goodwill = Total value of the business *Less* Net Tangible Assets = ₹ 33,33,333 – ₹ 28,50,000 = ₹ **4,83,333**.

Illustration 12

Following is the Balance Sheet of Rama Ltd. as at 31st March, 2016 :

Balance Sheet of Rama Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 60,000 Equity Shares of ₹ 10 each		6,00,000
(b) Reserves and Surplus — Profit and Loss Account		50,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		10,000
(b) Trade Payables — Sundry Creditors		60,000
(c) Short-term Provisions —		
Provision for Taxation		1,10,000
Proposed Dividend		60.000
TOTAL		8,90,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,70,000
(2) Current Assets :		
(a) Other Current Assets		5,20,000
TOTAL		8,90,000

The net profit of the company after deducting working expenses but before providing for taxation were as under :

2013-14	₹ 3,18,000
2014-15	₹ 3,40,000
2015-16	₹ 3,12,000

On 31st March, 2016 tangible fixed assets were revalued at ₹ 4,50,000. Sundry Debtors on the same date include ₹ 10,000 which is irrecoverable. Having regard to the type of business a 10% return on average capital employed is considered as reasonable.

Ascertain the value of goodwill on the basis of 3 years' purchase of annual super profits. Also calculate goodwill by capitalisation of average maintainable profits. Depreciation on tangible fixed assets is charged @ 10% p.a. and the rate of tax is 30%.

[C.S. (Inter) — Adapted]

Solution

(1) Calculation of Closing Capital Employed

Particulars		₹
Tangible Fixed Assets (Revalued)		4,50,000
Current Assets (₹ 5,20,000 – 10,000)		5,10,000
		9,60,000
Less: Bank Loan	10,000	
Sundry Creditors	60,000	
Provision for Taxation	1,10,000	1,80,000
Closing Capital Employed		7,80,000

(2) Computation of Average Capital Employed

Particulars	₹
Closing Capital Employed	7,80,000
Less: 1/2 of Adjusted Average Trading Profit after Tax (1/2 x 2,18,400) [Note 1]	1,09,200
	6,70,800

Value of Goodwill Based on Super Profit = 3 years' purchase of Super Profit
= 3 x ₹ 1,51,320 (Note 2)
= **₹ 4,53,960**

Working Notes :

(1) Calculation of Adjusted Average Trading Profit After Tax

Particulars	₹
Average Profit [3,18,000 + 3,40,000 + (3,12,000 – 10,000)] ÷ 3	3,20,000
Less: Depreciation @ 10% on Revaluation Profit of Tangible Fixed Assets (4,50,000 – 3,70,000)	(8,000)
	3,12,000
Less: Income Tax @ 30%	93,600
Average Maintainable Trading Profit after Tax	2,18,400

(2) Calculation of Average Super Profit

Particulars	₹
Average Maintainable Trading Profit after Tax	2,18,400
Less: Normal return on average capital employed (10% of ₹ 6,70,800)	67,080
Super Profit	1,51,320

Calculation of Goodwill by Capitalisation of Average Maintainable Profits

$$\text{Total Value of business} = \frac{\text{Average Maintainable Profits}}{\text{Normal Rate of Return}}$$

$$= \frac{2,18,400}{10} \times 100 = ₹\ \mathbf{21,84,000}$$

Goodwill = Total Value of business less Capital Employed (Closing)
= ₹ 21,84,000 – ₹ 7,80,000
= **₹ 14,04,000**

(4) Capitalisation of Super Profit Method

Under this method, goodwill is calculated by capitalising super profits at agreed rate :

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$$

The goodwill can be calculated directly by applying the following formula also :

$$Goodwill = \frac{p - rc}{m}$$

where, p = Adjusted forecast maintainable profit; r = Normal rate of return; c = Capital employed; and m = Capitalisation ratio.

Illustration 13

The following are the particulars about Gupta & Co., a partnership firm :

(a) Average capital employed in the business is ₹ 7,00,000.
(b) Net Trading Profit of the firm for the past three years : ₹ 1,07,600; ₹ 90,700; and ₹ 1,12,500.
(c) Market rate of interest on investments 8%.
(d) Rate of risk return on capital invested in business 2%.
(e) Fair remuneration to the partners for their services ₹ 12,000 per annum.
(f) The profit included non-recurring profits on average basis of ₹ 1,000 out of which it was considered that even non-recurring profits had a tendency to be recurring at an average rate of ₹ 600 per year.
(g) Sundry Assets of the firm ₹ 7,50,000 and Current Liabilities is ₹ 30,000.

Ascertain the value of Goodwill of the firm under the following methods :
(i) Three years' purchase of super profit method; and
(ii) Capitalisation method.
Ignore taxation

Solution

Average Profit = ₹ (1,07,600 + 90,700 + 1,12,500) / 3 = ₹ **1,03,600**.

Calculation of Super Profit

Particulars	₹
Average Profit	1,03,600
Less: Partners' Remuneration	12,000
	91,600
Less: Non-Recurring Income (₹ 1,000 – 600)	400
	91,200
Less: Normal Return on Capital Employed (10% of ₹ 7,00,000)	70,000
Super Profit	21,200

(1) Value of Goodwill = Super Profit × Number of Year's Purchase = ₹ 21,200 × 3 = ₹ **63,600**

(2) Valuation of Goodwill = $\frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100 = \frac{21,200}{10} \times 100$ = ₹ **2,12,000**

Illustration 14

The net profit of the business after tax, for the past five years are : ₹ 2,00,000; ₹ 2,12,500; ₹ 2,30,000; ₹ 2,62,500; and ₹ 2,95,000. The capital employed in the business is ₹ 20,00,000. The normal rate of return expected in this type of business is 10%. It is expected that the company will be able to maintain its super profit for the next 5 years. Calculate the value of goodwill on the basis of capitalisation of super profit method.

Solution

$$\text{Average Maintainable Profit} = \frac{2,00,000 + 2,12,500 + 2,30,000 + 2,62,500 + 2,95,000}{5}$$

= ₹ 12,00,000 / 5 = ₹ 2,40,000

$$\text{Goodwill} = \frac{P - rc}{m} = \frac{2,40,000 - 10\% \text{ of } 20,00,000}{10\%} = ₹\ 4,00,000$$

where,
P = Average maintainable profit = ₹ 2,40,000
r = Normal rate of return = 10%
c = Capital employed = ₹ 20,00,000
m = Capitalisation ratio = 10%.

Illustration 15

From the following information, calculate the value of goodwill as on 31.03.2017.

Equity Share Capital (₹ 10) ₹ 5,00,000.
10% Preference Share Capital ₹ 2,00,000.
Reserve and Surplus ₹ 70,000.
9% Debentures ₹ 1,00,000.
Depreciation Fund ₹ 60,000.
Creditors ₹ 50,000.
Assets side of Balance Sheet includes preliminary expenses ₹ 20,000.
Market value of assets is ₹ 70,000 more than the book value.
Profits for the last three years after 40% tax were : ₹ 75,000; ₹ 84,000; and ₹ 1,14,000 respectively.
Fair return on capital employed in this type of business is estimated at 10%.
You are required to calculate the value of goodwill by capitalisation of super profit. (Take weighted average profit.)

Solution

Calculation of Capital Employed

Particulars	₹
Equity Share Capital	5,00,000
10% Preference Share Capital	2,00,000
Reserve and Surplus	70,000
9% Debentures	1,00,000
Increase in the Value of Fixed Assets	70,000
	9,40,000
Less: Preliminary Expenses	20,000
Capital Employed	9,20,000

Calculation of Weighted Average profit

Particulars	₹
Weighted Average Profit (Note 1) after Tax	97,500
Add: Debenture Interest (net of tax) $\left(\frac{100-40}{100}\right) \times \left(1,00,000 \times \frac{9}{100}\right)$	5,400
Weighted Average Profit	1,02,900

Calculation of Super profit

Particulars	₹
Weighted Average Profit	1,02,900
Less: Normal Profit (10% of ₹ 9,20,000)	92,000
Super Profit	10,900

Goodwill by Capitalsation of Super Profit :

$$\text{Goodwill} = \frac{\text{Super profit}}{\text{Normal Rate of Return}} = \frac{10,900}{10\%} = ₹\ \mathbf{1,09,000}$$

Working Notes :

(1) Profits for last 3 years (after tax) have been given. The profit is increasing steadily. Therefore the highest weight should be given to 3rd year and lowest wieght should be given to 1st year. Based on this, the weighted average profit will be as follows :

1st year — ₹ 75,000 × 1	75,000
2nd year — ₹ 84,000 × 2	1,68,000
3rd year — ₹ 1,14,000 × 3	3,42,000
Total	5,85,000

Weighted Average Profit — $\frac{5,85,000}{6}$ = ₹ 97,500.

(5) Annuity Method

An annuity is a series of equal periodic payments occuring at equal intervals of time. Under this method, goodwill is calculated by taking the average super profit as the value of an annuity over a certain number of years. The present value of the above annuity, discounted at the given rate of interest (normal rate of return) is the value of the goodwill.

If the value of annuity is not given, the following formula can be applied for valuing goodwill :

$$V = \frac{a}{i}\left[1 - \frac{1}{(1 + i)^n}\right]$$

where,

V = value of the goodwill;
a = average super profit;
i = rate of interest per annum;
n = number of years.

Illustration 16

The net profit of a company after providing for taxation for the past five years are :

₹ 40,000; ₹ 50,000; ₹ 30,000; ₹ 70,000 and ₹ 80,000.

The net tangible assets in the business is ₹ 4,00,000 on which the normal rate of return is expected to be 10%. It is also expected that the company will be able to maintain its super profits for next five years.

Calculate the value of goodwill of the business on the basis of an annuity of super profits, taking the present value of an annuity of one rupee for five years at 10% interest is ₹ 3.78.

Solution

Calculation of Average Profits

Particulars	₹
1st Year	40,000
2nd Year	50,000
3rd Year	30,000
4th Year	70,000
5th Year	80,000
Total Profit	2,70,000
Average Profits = ₹ 2,70,000 / 5 = ₹ 54,000	

Calculation of Super Profits

Particulars	₹
Average Profits	54,000
Less: Normal return on capital employed	
(10% of ₹ 4,00,000)	40,000
Super Profits	14,000

Goodwill = Super Profit x Value of an annuity
Goodwill = ₹ 14,000 × 3.78 = ₹ **52,920**.

Valuation of Purchased Goodwill

The method of valuation of purchased goodwill compares the value of the net tangible and identifiable intangible assets with the bargained purchase price of the business which is acquired. The difference is the value of the goodwill.

Therefore, purchased goodwill is the residual or the excess of the cost over the fair value of the identifiable net assets acquired.

Valuation of Shares

A share represents an interest in a company. There are a number of ways in which the shares of a company may be valued. It can be valued either as an entitlement to a share of future profits, or as an interest in the net assets that comprise the company. Therefore, the choice of method of valuation is often governed by the reasons for the investment. The majority of shareholders of a company are interested in dividends. On the other hand, a majority of shareholders may be interested in the realisable value of the company's net assets since they can liquidate a company.

There may be instances where a company's shares are not quoted on any stock exchange. The ability to place realistic valuations on such investments is of great importance.

Need for Valuation

(1) When two or more companies amalgamate or one company absorbs another company, it is necessary to form a fair and equitable basis of valuation for transferring the shares. The prices quoted in the stock exchange, if any, do not properly indicate the actual value of the shares. For formulating amalgamation and absorption schemes, a fresh valuation method should be taken up.

(2) When a company has decided to undergo a process of reconstruction, to protect the rights of the dissenting shareholders, a fresh valuation of shares should be taken up. The dissenting shareholders should be paid as per the valuation of shares in respect of their holdings.

(3) When preference shares or debentures are converted into equity shares, a fresh valuation method should be adopted for equity shares to calculate exchange ratio. It is necessary to ascertain the number of equity shares required to be issued (based on the new valuation) for debentures as preference shares.

(4) Shares are often pledged as security for raising loans. In such cases, fresh valuation of shares is necessary to know the real worth of shares on the basis of which loan is to be provided.

(5) When one company acquires majority of the shares of another company, it is necessary to value such shares.

(6) The survivor of a deceased person, who gets some shares of a company made by the will, may require the valuation of such shares, which are not quoted in the stock exchange, for estate duty purposes.

(7) Under a scheme of nationalisation, when the shares of a company are taken over by the Government, it is necessary to value the shares for reasonable compensation to the holders.

(8) When a partnership firm is dissolved and the firm is having some investment in shares, it is necessary to value those shares for proper distribution among the partners.

Factors Affecting Valuation of Shares

(1) The nature of the company's business.
(2) Percentage of dividend declared on the shares.
(3) The demand and supply of shares.
(4) The income yielding capacity of the company.
(5) The availability of sufficient assets over liabilities.
(6) General economic conditions, e.g., availability of raw materials, possibility of new competition.
(7) Financial, political and other factors affecting the business.
(8) The fact that there is no free market for unquoted shares.

Methods of Valuation

There are two widely applied methods for the valuation of shares :

(a) The Assets Backing Method; and (b) The Yield Valuation Method.

There are also circumstances where one method of valuation would not be suitable. In such circumstances, a number of alternative methods may be used as a broad framework in which to agree on a valuation.

Asset Backing Method

This method is also known as ***Asset-Valuation Method or Intrinsic Value Method***. Under this method, the share's value is simply the net assets, or equity, divided by the number of shares. The value of a share is first determined by ascertaining the value of net assets of a company and then dividing them by the number of shares. Therefore, it is necessary to estimate the worth of the assets and liabilities. In ascertaining the amount of net assets, the ***value of goodwill*** as well as the ***value of any contingent assets and liabilities*** should also be taken into consideration.

The following points are important and should be borne in mind for estimating the net assets :

(1) The fixed assets of the company should be revalued at their net realisable value.

(2) Inventory should be taken at current market prices.

(3) Investments should also be taken at current market prices. These can be taken at cost if the fall in the market value is believed to be temporary.

(4) Other current assets like Bills Payable or Sundry Debtors should be valued at their expected net realisable value.

(5) All useless assets appearing in the Balance Sheet are to be eliminated.

(6) Goodwill may be valued on the basis of super profits.

(7) All unrecorded assets and liabilities are to be taken into consideration.

From the aggregate value of the assets, all external liabilities are to be deducted to arrive at the net assets figure. The external liabilities include Sundry Creditors, Bills Payable, Loans, Debentures, etc.

The net assets of a company, as ascertained above, will be the basis of valuation of shares, and would be apportioned in the following manner :

(1) If the preference shareholders have priority to dividend as well as to capital on a winding-up, they will be valued at par if they expect the same rate of dividend as specified in the shares. But if the required rate of return is more than the specified rate, they are to be valued above par to cover both capital and dividend.

(2) After deducting the value of preference shares, as calculated above, from the net assets, the balance will be divided by the number of equity shares. The resultant figure will be the value of each equity share.

The Assets Backing Method is generally applied under the following circumstances :

(1) For formulating schemes of amalgamation;

(2) For acquiring majority of the shares and controlling the company;

(3) When there is a liquidation.

Illustration 17

The following particulars are available in relation to A Ltd. :

(i) Equity share capital 5,000 equity shares of ₹ 20 each.

(ii) Preference share capital 1,000, 8% Preference shares of ₹ 100 each.

(iii) Reserves ₹ 30,000.

(iv) Current Liabilities ₹ 18,000.

(v) Loss on revaluation of fixed assets ₹ 12,000.

(vi) Average trading profit ₹ 30,000 (after tax).

(vii) Normal rate of return on capital employed 10%.

(viii) Goodwill should be valued at 3 years' purchase of Super Profit.

Calculate intrinsic value per equity share.

Solution **(1) Calculation of Capital Employed**

Particulars	₹
Equity Shares Capital	1,00,000
8% Preference Share Capital	1,00,000
Reserves	30,000
	2,30,000
Less: Loss on Revaluation	12,000
Capital Employed	2,18,000

(2) Calculation of Super Profit

Particulars	₹
Average Trading Profit after Tax	30,000
Less: Normal Return (10% of capital employed)	21,800
Super Profit	8,200

(3) Value of Goodwill = 3 years' purchase of Super Profit = 3 × ₹ 8,200 = ₹ **24,600**.

(4) Valuation of Shares under Intrinsic Value Method

Particulars	₹
Capital Employed (as in (1) above)	2,18,000
Less: Preference Shareholder's Claim	1,00,000
	1,18,000
Add: Goodwill (As valued in (3) above]	24,600
	1,42,600
Number of Equity Shares	5,000
Value per Share (₹ 1,42,600 / 5,000)	₹ 28.52

Illustration 18

The Balance Sheet of X Ltd. as at 31st March, 2016 showed the following position :

Balance Sheet of X Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 20,000 Equity Shares of ₹ 100 each		20,00,000
(b) Reserves and Surplus — General Reserve		6,00,000
Profit and Loss Account		3,50,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		3,00,000
(b) Trade Payables — Creditors		4,00,000
(c) Short-term Provisions — Provision for Taxation		5,00,000
TOTAL		41,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		
Factory Premises		11,50,000
Plant		10,00,000
(2) Current Assets :		
(a) Inventories — Stock-in-trade		15,00,000
(b) Trade Receivables — Debtors		5,00,000
TOTAL		41,50,000

Additional information :

(i) Net profits of the company for the last five years before providing for taxation were as follows : ₹ 4,10,000; ₹ 6,40,000; ₹ 7,00,000; ₹ 8,50,000; ₹ 9,00,000.

(ii) Managerial remuneration of ₹ 60,000 has been charged for each year.

(iii) The market value of the assets were : Inventories— ₹ 15,50,000; Plant — ₹ 10,40,000; Factory premises — ₹ 12,83,000.

(iv) Taxation may be considered at 50%.

(v) Goodwill should be valued at 5 years' purchase of super profits.

(vi) Normal rate of return — 10% p.a.

On the basis of the above information, find out the intrinsic value of shares. Indicate assumptions, if any, clearly.

Solution **(1) Calculation of Capital Employed**

Net Assets Basis			Net worth Basis		
Assets	₹	₹		₹	₹
Debtors	5,00,000		Equity Share Capital	20,00,000	
Inventories in hand	15,50,000		General Reserve	6,00,000	
Plant	10,40,000		Profit and Loss Account	3,50,000	29,50,000
Factory Premises	12,83,000	43,73,000	Add: Revaluation Profit :		
Less: Outside Liabilities :			Inventories ₹ (15,50,000 – 15,00,000)	50,000	
Bank Loan	3,00,000		Plant ₹ (10,40,000 – 10,00,000)	40,000	
Creditors	4,00,000		Factory Premises (12,83,000 – 11,50,000)	1,33,000	2,23,000
Provision for Taxation	5,00,000	12,00,000	**Capital Employed**		31,73,000
Capital Employed		31,73,000			

(2) Calculation of Super Profit

Particulars	₹
Average maintainable trading profit (₹ 4,10,000 + ₹ 6,40,000 + ₹ 7,00,000 + ₹ 8,50,000 + ₹ 9,00,000) / 5	7,00,000
Add back managerial remuneration	60,000
	7,60,000
Less: Managerial remuneration (maximum 11% allowable under Companies Act, 1956)	83,600
Profit before Tax	6,76,400
Less: Tax 50%	3,38,200
Profit after Tax	3,38,200
Less: Normal return — 10% on Capital Employed	3,17,300
Super Profit	20,900

(3) Valuation of Goodwill

Goodwill is to be valued on the basis of 5 years' purchase of super profit. Therefore, the goodwill will be ₹ 20,900 x 5 = ₹ 1,04,500.

(4) Valuation of Shares under Intrinsic Value Method

Particulars	₹
Net assets as in (1) above	31,73,000
Goodwill as in (3) above	1,04,500
	32,77,500
Number of Shares	20,000
Value per share (₹ 32,77,500 / 20,000)	₹ 163.875

Assumption : No depreciation has been charged on increased value of different assets.

Illustration 19

Following is the Balance Sheet of Ramesh Ltd. as on 31st March, 2016 :

Balance Sheet of Ramesh B Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	20,00,000
(b) Reserves and Surplus — General Reserve		3,80,000
Profit and Loss Account		4,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 15% Debentures		10,00,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		8,00,000
TOTAL		45,80,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Building		15,00,000
Plant		10,00,000
(ii) Intangible Assets — Goodwill		5,00,000
(b) Non-current investments — 10% Stock in A Ltd. (Nominal value ₹ 5,00,000)		4,80,000
(2) Current Assets :		
(a) Inventories		6,00,000
(b) Trade Receivables — Debtors		4,00,000
(c) Cash and Cash Equivalents — Cash		1,00,000
TOTAL		45,80,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000
10,000, 12% Preference Shares of ₹ 100 each fully paid	10,00,000
	20,00,000

Additional information :

Assets are revalued as follows :

Building — ₹ 32,00,000; Plant — ₹ 18,00,000; Inventories — ₹ 4,50,000; and Debtors — ₹ 3,60,000.

Average profit before tax of the company is ₹ 12,00,000 and 12.5% of the profit is transferred to General Reserve, rate of taxation being 50%. Normal dividend expected on equity shares is 8% while fair return of capital employed is 10%,. Goodwill may be valued at 3 years' purchase of super profits.

Ascertain the value of each equity share under assets backing method. ***[C.S. — Adapted]***

Solution

(1) Calculation of Capital Employed

Particulars	₹
Assets :	
Building	32,00,000
Plant	18,00,000
Inventories	4,50,000
Debtors	3,60,000
Cash	1,00,000
	59,10,000
Less: Liabilities :	
Sundry Creditors	8,00,000
Capital Employed	51,10,000

(2) Calculation of Average Trading Profit

Particulars	₹
Average Profit before Tax	12,00,000
Add: Interest on Debentures	1,50,000
	13,50,000
Less: Income from Investment	50,000
	13,00,000
Less: Income Tax 50%	6,50,000
Net Profit after Tax	6,50,000

Tutorial Note : Goodwill appearing in the Balance Sheet is ₹ 5,00,000. This goodwill value will not be taken for calculating ***Capital Employed***.

(3) Calculation of Super Profit

Particulars	₹
Net Profit after Tax	6,50,000
Less: Normal Profit — 10% of ₹ 51,10,000	5,11,000
Super Profit	1,39,000

Goodwill = 3 years' purchase of Super profit

= 3 × ₹ 1,39,000

= ₹ **4,17,000**

Computation of Net Assets Available to Equity Shareholders

Particulars	₹
Capital Employed	51,10,000
Add: Goodwill (as calculated above)	4,17,000
	55,27,000
Less: Long-term Borrowings — 15% Debentures	10,00,000
	45,27,000
Less: Preference Share Capital	10,00,000
	35,27,000
Add: Non-current Investment	4,80,000
Net Assets Available to Equity Shareholders	40,07,000

Value of Equity Share under Asset Backing Method

$$\text{Value of each Equity Share} = \frac{\text{Net Assets available to Equity Shareholders}}{\text{Total Number of Equity Shares}} = \frac{40,07,000}{1,00,000} = ₹\ \mathbf{40.07}$$

Yield Valuation Method

This method is also known as ***Market Value Method***. The word 'yield' means a rate of return relating cash invested to cash received (or expected to be received). Yield may be 'Earning yield' or 'Dividend yield'. They are as under:

(i) Earning Yield

A company cannot grow and can never be in a position to increase its dividends, if it distributes all of its profits as dividends. There are also legal restrictions by the Companies Act for distribution of profits as dividends. Therefore, a shareholder will have interest both in the retained profits as well as distributed profits. Under this method, shares are valued on the basis of the ***earnings expected*** by using an average of recent years as the best indicator of what future earnings of the company will be. Under this method, value of each share is calculated by applying the following formula :

$$\text{Value Per Share} = \frac{\text{Expected Rate of Earnings (ERE)}^{*}}{\text{Normal Rate of Return (NRR)}} \times \text{Face Value of Share}$$

$$^{*}\ \text{Expected Rate of Earnings (ERE)} = \frac{\text{Profit after Tax}}{\text{Paid–up Value of Shares}} \times 100$$

While fixing the normal rate of return, the degree of risk involved and the current rate of interest on gilt-edged securities should also be taken into consideration.

Illustration 20

From the following information of P. Merchandise Co. Ltd., compute the value of its equity shares by earnings yield method.

Balance Sheet of P. Merchandise Co. Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 25,000 Equity Shares of ₹ 10 each fully paid		2,50,000
(b) Reserves and Surplus — Profit and Loss Account		75,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		2,50,000

(4) Current Liabilities :		
(a) Other Current Liabilities		2,25,000
TOTAL		8,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		5,00,000
(2) Current Assets :		
(a) Other Current Assets		3,00,000
TOTAL		8,00,000

	Year ending 31st December				
Particulars	2011 (₹)	2012 (₹)	2013 (₹)	2014 (₹)	2015 (₹)
Sales	6,00,000	7,00,000	8,00,000	5,00,000	9,00,000
Operating costs	3,45,000	3,95,000	4,45,000	2,95,000	4,95,000
Interest on Loan from Bank	25,000	25,000	25,000	25,000	25,000

Assume rate of taxation at 60% and the rate of normal earnings at $12^1/_2$%. Also show the workings.

Solution

Calculation of Average Profit

Particulars	2011 (₹)	2012 (₹)	2013 (₹)	2014 (₹)	2015 (₹)
Sales	6,00,000	7,00,000	8,00,000	5,00,000	9,00,000
Less: Operating Cost	3,45,000	3,95,000	4,45,000	2,95,000	4,95,000
Profit before interest and tax (PBIT)	2,55,000	3,05,000	3,55,000	2,05,000	4,05,000
Less: Interest on bank loan	25,000	25,000	25,000	25,000	25,000
Less: Interest on Debentures	30,000	30,000	30,000	30,000	30,000
Profit before tax (PBT)	2,00,000	2,50,000	3,00,000	1,50,000	3,50,000
Less : Tax @ 60%	1,20,000	1,50,000	1,80,000	90,000	2,10,000
Profit after tax (PAT)	80,000	1,00,000	1,20,000	60,000	1,40,000

$$\text{Average Profit} = \frac{80{,}000 + 1{,}00{,}000 + 1{,}20{,}000 + 60{,}000 + 1{,}40{,}000}{5} = ₹\ 1{,}00{,}000\ ;$$

$$\text{Expected Rate of Earnings on Capital} = \frac{1{,}00{,}000}{2{,}50{,}000} \times 100 = 40\%$$

Normal rate of return = 12.5% (given)

$$\text{Value Per Share} = \frac{\text{Expected Rate of Earnings}}{\text{Normal Rate of Return}} \times \text{Face Value of Share} = \frac{40\%}{12.5\%} \times ₹\ 10 = ₹\ \mathbf{32}$$

Illustration 21

From the following Balance Sheet of J. Adams Co. Ltd. as on 31.12.2015, compute the value of its equity shares by Earning Yield Method :

Balance Sheet of J Adams Co. Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 50,000 Equity Shares of ₹ 10 each		5,00,000
(b) Reserves and Surplus — Profit and Loss Account		1,25,000
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		3,00,000
(4) Current Liabilities :		
(a) Other Current Liabilities		2,50,000
TOTAL		11,75,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		6,00,000
(2) Current Assets :		
(a) Other Current Assets		5,75,000
TOTAL		11,75,000

Particulars		31.12.2011	31.12.2012	31.12.2013	31.12.2014	31.12.2015
Sales	₹	9,00,000	11,00,000	14,00,000	8,00,000	16,00,000
Expenses	₹	3,50,000	5,80,000	6,00,000	3,10,000	8,00,000
Interest on Loan	₹	20,000	40,000	50,000	60,000	20,000
Interest on Debentures	₹	30,000	30,000	30,000	30,000	30,000

It is the usual practice of the company to transfer ₹ 30,000 every year to General Reserve. Assume rate of taxation at 50% and the rate of normal earnings at 12.5%. Also show the workings.

Solution **Calculation of Average Profit**

Particulars	2011 (₹)	2012 (₹)	2013 (₹)	2014 (₹)	2015 (₹)
Sales	9,00,000	11,00,000	14,00,000	8,00,000	16,00,000
Less: Expenses	3,50,000	5,80,000	6,00,000	3,10,000	8,00,000
Profit before interest and tax (PBIT)	5,50,000	5,20,000	8,00,000	4,90,000	8,00,000
Less: Interest on Loan	20,000	40,000	50,000	60,000	20,000
Less: Interest on Debentures	30,000	30,000	30,000	30,000	30,000
Profit before tax (PBT)	5,00,000	4,50,000	7,20,000	4,00,000	7,50,000
Less: Tax @ 50%	2,50,000	2,25,000	3,60,000	2,00,000	3,75,000
Profit after tax (PAT)	2,50,000	2,25,000	3,60,000	2,00,000	3,75,000

$$\text{Average Profit} = \frac{2{,}50{,}000 + 2{,}25{,}000 + 3{,}60{,}000 + 2{,}00{,}000 + 3{,}75{,}000}{5} = ₹\ 2{,}82{,}000.$$

$$\text{Expected Rate of Earnings} = \frac{2{,}82{,}000}{5{,}00{,}000} \times 100 = 56.4\%$$ Normal Rate of Return = 12.5% (given).

$$\text{Value Per Share} = \frac{\text{Expected Rate of Earnings}}{\text{Normal Rate of Return}} \times \text{Face Value of Share} = \frac{56.4\%}{12.5\%} \times ₹\ 10 = ₹\ 45.12$$

Alternatively,

Capitalised value of the business based on earnings = ₹ 2,82,000 / 12.5% = ₹ 22,56,000.

$$\text{Value Per Share} = \frac{\text{Capitalised Value of Business}}{\text{Number of Equity shares}} = \frac{22{,}56{,}000}{50{,}000} = ₹\ 45.12$$

Tutorial Note : Amount transferred to reserve ₹ 30,000 should not be taken into consideration for calculation of value of shares under this method.

(ii) Dividend Yield

There may be circumstances where the shareholder has little or no influence over dividend policy. In such cases, it may be more appropriate to value the shares based on dividends than earnings.

The following matters must be taken into consideration while making an estimate of the expected future profits available for equity share dividends :

(1) The average past profits of the company require an adjustment, if necessary, should any special factor(s) cause the future profits to differ from the past.
(2) Adequate provision should be made for depreciation, taxation and other liabilities.
(3) The amount of profits to be set aside for preference share dividend.

In connection with the valuation of shares on the yield basis, the following points may be given due consideration :

(1) Depending on the circumstances, the average rate of return is generally taken for three to five years.
(2) During a period of time, if the profits fluctuate violently, it is better to eliminate abnormal periods, where the profits earned are too high or too low.
(3) The rate of dividend is dependent on the liquid position of the company. If the liquidity position of the company is not satisfactory, it will not be in a position to declare adequate rate of dividend though the company earned adequate rate of earnings.

Under this method, shares are valued on the basis of the expected dividends.

The following formula is adopted for valuation of shares :

$$\text{Value Per Share} = \frac{\text{Expected Rate of Dividend (ERD)}}{\text{Normal Rate of Return (NRR)}} \times \text{Paid–up Value of Share}$$

Illustration 22

From the following information, calculate the value of an equity share by Dividend Yield Method:

(i) The paid-up share capital of a company consists of 1,000, 15% Preference Shares of ₹ 100 each and 20,000 Equity Shares of ₹ 10 each.
(ii) The average annual profits of the company, after providing for depreciation and taxation amounted to ₹ 75,000. It is considered necessary to transfer ₹ 10,000 to General Reserve before declaring any dividend.
(iii) The normal return expected by investors on equity shares from the type of business carried on by the company is 10%.

Solution

Calculation of Expected Rate of Dividend

Particulars	₹
Profit after tax	75,000
Less: Transferred to General Reserve	10,000
	65,000
Less: Preference dividend @ 15% on ₹ 1,00,000	15,000
Profits available to Equity Shareholders	50,000

Dividend Yield Method of Valuation

$$\text{Value Per Share} = \frac{\text{Expected Rate of Dividend}*}{\text{Normal Rate of Return}} \times \text{Paid–up Value}$$

$$= \frac{25\%}{10\%} \times ₹\,10 = ₹\,25$$

$$*\text{Expected Rate of Dividend} = \frac{\text{Profit available for Dividend}}{\text{Total paid–up Equity Share Capital}} \times 100 \quad = \frac{50{,}000}{2{,}00{,}000} \times 100 = 25\%$$

Illustration 23

The following particulars are available in relation to Hari Pvt. Ltd. Co.

(i) Capital : 6,000, 6% Preference Shares of ₹ 100 each fully paid and 5,000 equity shares of ₹ 100 each fully paid.
(ii) External Liabilities ₹ 75,000.
(iii) Reserve and Surplus ₹ 50,000.
(iv) The average expected profit (after tax) ₹ 90,000.
(v) The normal profit earned on the market value of equity shares of the same type of company — 10%.
(vi) Transfer to Reserve 10% of the Net Profit.

Calculate value per Equity Share according to Dividend Yield Basis.

Solution

Calculation of Expected Rate of Dividend | **Dividend Yield Method of Valuation**

Particulars	₹
Average expected Profit after tax	90,000
Less: Transferred to General Reserve (10%)	9,000
	81,000
Less: Preference dividend @ 6% on ₹ 6,00,000	36,000
Profits available to Equity Shareholders	45,000

$$\text{Value Per Share} = \frac{\text{Expected Rate of Dividend}*}{\text{Normal Rate of Return}} \times \text{Paid–up Value}$$

$$= \frac{9\%}{10} \times 100 = ₹\,90$$

$$*\text{Expected Rate of Dividend} = \frac{\text{Profit available for Dividend}}{\text{Total paid–up Equity Share Capital}} \times 100 \quad = \frac{45{,}000}{5{,}00{,}000} \times 100 = 9\%$$

Illustration 24

From the following information relating to a company, calculate the value of its equity shares.

Issued equity share capital — 10,000 shares of ₹ 10 each; Paid-up equity share capital — ₹ 8 per share.

6% Preference share capital — 1,00,000 shares of ₹ 10 each fully paid; Annual transfers to general reserve — 20%.

Rate of tax — 50%; Expected profits before tax — ₹ 2,00,000.

Normal rate of return — 20%.

Solution

Calculation of Expected Rate of Dividend | **Dividend Yield Method of Valuation**

Particulars	₹
Expected Profits (before tax)	2,00,000
Less: Income tax @ 50%	1,00,000
Profit after tax	1,00,000
Less: Transferred to General Reserve @ 20%	20,000
	80,000
Less: Preference Dividend : 6% on ₹ 10,00,000	60,000
Profits available to Equity Shareholders	20,000

$$\text{Value Per Share} = \frac{\text{Expected Rate of Dividend}*}{\text{Normal Rate of Return}} \times \text{Paid–up Value}$$

$$= \frac{25\%}{20\%} \times ₹\,8 = ₹\,10$$

$$*\text{Expected Rate of Dividend} = \frac{\text{Profit available for Dividend}}{\text{Total paid–up Equity Share Capital}} \times 100 \quad = \frac{20{,}000}{80{,}000} \times 100 = 25\%$$

Illustration 25

Following particulars are available in relation to A Ltd. :

(a) Equity share capital — 4,000 equity shares of ₹ 100 each fully paid.
(b) 1,000, 8% Preference Shares of ₹ 100 each.
(c) Reserve and Surplus — ₹ 1,25,000.
(d) 10% Debentures — ₹ 4,00,000.
(e) Profit on revaluation of assets — ₹ 92,000.
(f) EBDIT — ₹ 2,74,000.
(f) Depreciation — ₹ 50,000.
(g) Income tax rate is 30%.
(h) E/P ratio in the industry is 1/8 and dividend yield is 16%.
(i) During the last three years, the company paid dividend at 20%, 19% and 27% respectively.

Calculate the market price of each equity share under ***Earnings Method*** and under ***Dividend Method***.

Solution **Calculation of Earnings of Equity Shareholders**

Particulars	₹
Earning before Depreciation, Interest and Tax (EBDIT)	2,74,000
Less: Depreciation	50,000
Earning before Interest and Tax (EBIT)	2,24,000
Less: Interest on Debentures (10% of ₹ 4,00,000)	40,000
	1,84,000
Less: Profit on Revaluation of Assets (Note 1)	92,000

Trading Profit / Operating Profit before Tax	92,000
Less: Income Tax @ 30%	27,600
Profit after Tax (PAT)	64,400
Less: Preference Dividend (8% of ₹ 1,00,000)	8,000
Profit available to Equity Shareholders	56,400

$$\text{Expected Rate of Earning} = \frac{\text{Profit Available to Equity Shareholders}}{\text{Paid–up Value of Equity Shares}} \times 100$$

$$= \frac{56{,}400}{4{,}00{,}000} \times 100 = \mathbf{14.1\%}$$

Normal Rate of Return = E/P × 100

$$= \frac{1}{8} \times 100 = \mathbf{12.5\%}$$

(i) Calculation of Value per Share under Earning Method

$$\text{Value of Each Share} = \frac{\text{Expected Rate ofEarning (ERE)}}{\text{Normal Rate of Return (NRR)}} \times \text{Face Value Per Share}$$

$$= \frac{14.1\%}{12.5\%} \times 100 = \text{₹ } \mathbf{112.80}$$

(ii) Calculation of Value Per Share under Dividend Method

$$\text{Expected Rate of Dividend} = \frac{20\% + 19\% + 27\%}{3} = 22\%$$

$$\text{Value per Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid–up Value}$$

$$= \frac{22\%}{16\%} \times 100 = \text{₹ } \mathbf{137.50}$$

Illustration 26

Following are the information of two companies for the year ended 31st March, 2010 :

	Company A (₹)	Company B (₹)
Equity Shares of ₹ 10 each	8,00,000	10,00,000
10% Preference Shares of ₹ 10 each	6.00.000	4.00.000
Profit after Tax	3,00,000	3,00,000

Assuming that the market expectation is 18% and 80% of the profits are distributed, what is the price per share you would pay for the equity shares of each company —

(i) if you are buying a small lot; and

(ii) if you are buying controlling interest shares ?

[C.S. (Inter) — December, 2010]

Solution **Calculation of Earning Per Share and Dividend Per Share**

Particulars	Company A (₹)	Company B (₹)
Profit after Tax	3,00,000	3,00,000
Less: Preference Dividend @ 10%	60,000	40,000
Profits Available to Equity Shareholders	2,40,000	2,60,000
Number of Equity Shares	80,000	1,00,000
Earning Per Shares = $\frac{\text{Profit Available to Equity Shareholders}}{\text{Number of Equity Shares}}$	₹ 3.00	₹ 2.60
Expected Rate of Earning = $\frac{\text{EPS}}{\text{Face Value}} \times 100$	$\frac{3}{10} \times 100 = 30\%$	$\frac{2.6}{10} \times 100 = 26\%$
Divisible Profit as Dividend : 80% of Profits available to Equity Shareholders as dividend	₹ 1,92,000	₹ 2,08,000
Dividend per Share = $\frac{\text{Divisible Profit as Dividend}}{\text{Number of Equity Shares}}$	₹ 2.40	₹ 2.08
Expected Rate of Dividend = $\frac{\text{DPS}}{\text{Face Value}} \times 100$	$\frac{2.4}{10} \times 100 = 24\%$	$\frac{2.08}{10} \times 100 = 20.8\%$

Value per Share for Buying a Small Lot

In this case, the basis for valuation of equity shares will be 'Expected Rate of Dividend'. Therefore, the value per share will be —

$$\text{Company A} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Face Value}$$

$$= \frac{24\%}{18\%} \times 10 = \textbf{₹ 13.33}$$

$$\text{Company B} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Face Value}$$

$$= \frac{20.08\%}{18\%} \times 10 = \textbf{₹ 11.16}$$

Value per Share for Buying Controlling Interest

In this case, the basis for valuation of equity shares will be 'Expected Rate of Earnings'. Therefore, the value per share will be —

$$\text{Company A} = \frac{\text{Expected Rate of Earnings}}{\text{Normal Rateof Earnings}} \times \text{Face Value}$$

$$= \frac{30\%}{18\%} \times 10 = \textbf{₹ 16.67}$$

$$\text{Company B} = \frac{\text{Expected Rate of Earnings}}{\text{Normal Rateof Earnings}} \times \text{Face Value}$$

$$= \frac{26\%}{18\%} \times 10 = \textbf{₹ 14.44}$$

General Illustrations

Illustration 27

The Balance Sheet of Black Stone Ltd. as at 31st March, 2016 is as under :

Balance Sheet of Black Stone Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 40,000 Equity Shares of ₹ 10 each		4,00,000
(b) Reserves and Surplus — General Reserve		90,000
Profit and Loss Account		20.000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6% Debentures		1,00,000
(4) Current Liabilities :		
(a) Other Current Liabilities		1,30,000
TOTAL		7,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		5,00,000
(ii) Intangible Assets — Goodwill		40,000
(2) Current Assets :		
(a) Other Current Assets		2,00,000
TOTAL		7,40,000

On 31st March, 2016 the tangible fixed assets were independently valued at ₹ 5,50,000 and the goodwill at ₹ 50,000. The net profits after tax for the three years were :

2013-14 : ₹ 51,600; 2014-15 : ₹ 52,000; and 2015-16 : ₹ 51,650 of which 20% was placed to reserve, this proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 10%.

Compute the value of the company's shares by (a) the assets backing method and (b) the dividend yield method.

Solution

Assets Backing Method of Valuation

Particulars		₹
Assets :		
Goodwill (as per valuation)		50,000
Fixed Assets (as per valuation)		5,50,000
Current Assets		2,00,000
	[A]	8,00,000
Liabilities :		
5% Debentures		1,00,000
Current Liabilities		1,30,000
	[B]	2,30,000
Net worth	[A – B]	5,70,000
Value of each share = ₹ 5,70,000 / 40,000 = ₹ 14.25		

Dividend Yield Method of Valuation

Particulars		₹
Net Profit for	2013-14	51,600
	2014-15	52,000
	2015-16	51,650
Total Profit		1,55,250
Average Profit (₹ 1,55,250 / 3)		51,750
Less: Transferred to Reserve (20% of ₹ 51,750)		10,350
Profit available for Dividend		41,400

Expected Rate of Dividend = ₹ 41,400 / 4,00,000 x 100 = 10.35%

$$\text{Value Per Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid–up Value}$$

$$= \frac{10.35\%}{10\%} \times ₹\ 10 = ₹\ \mathbf{10.35}$$

Illustration 28

The following particulars of a company are available :

(1) Equity share capital : 10,000 equity shares of ₹ 10 each fully paid.
(2) Preference share capital : 1,000, 12% preference shares of ₹ 100 each fully paid.
(3) Reserve and Surplus : ₹ 15,000.
(4) External Liabilities : Creditors — ₹ 12,000; Bills payable — ₹ 6,000.
(5) The average normal profit after tax earned each year by the company ₹ 28,500.
(6) Transferred to general reserve — 10%.

Assets of the company include one fictitious item of ₹ 800. The normal rate of return in respect of the equity share of this type of company is ascertained at 10% (ignore goodwill).

Compute the value of the company's share by —

(a) the asset backing method; and,
(b) yield method.

Solution

Assets Backing Method of Valuation

Particulars	₹
Equity Shares	1,00,000
Add: Reserve and Surplus	15,000
	1,15,000
Less: Fictitious Assets	800
Net worth available to equity shareholders	1,14,200

Value of each equity share = ₹ 1,14,200 / 10,000 = ₹ 11.42

Tutorial Note :

Net worth of a business can be calculated in two ways :
(i) Assets *less* liabilities
or
(ii) Share capital plus reserve and surplus *less* fictitious assets.

In this problem, value of different assets are not given. Therefore, networth has been calculated on the basis of share capital plus reserve and surplus *less* fictitious assets. Here, creditors and bills payable are to be ignored.

Yield Method of Valuation

Particulars	₹
Average Annual Profit (after tax)	28,500
Less: Transferred to General Reserve @ 10%	2,850
	25,650
Less: Preference Dividend (12% on ₹ 1,00,000)	12,000
Profit available for Dividend to Equity Shareholders	13,650

$$\text{Expected Rate of Dividend} = \frac{\text{Profit available for Dividend}}{\text{Total paid–up Equity Share Capital}} \times 100$$

$$= \frac{13{,}650}{1{,}00{,}000} \times 100 = 13.65\%$$

$$\text{Value Per Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid–up Value}$$

$$= \frac{13.65\%}{10\%} \times ₹\,10 = ₹\,\mathbf{13.65}$$

Illustration 29

Balance Sheet of Fortunate Ltd. as on 31.3.2016 is as under :

Balance Sheet of Fortune Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	15,00,000
(b) Reserves and Surplus — General Reserve		1,50,000
Profit and Loss Account		10,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Bank Loan		1,50,000
(b) Gratuity Payable		75,000
(4) Current Liabilities :		
(a) Trade Payables — Creditors		1,50,000
TOTAL		20,35,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Plant and Machinery (at cost)	5,00,000		
Less: Depreciation Fund	50,000		4,50,000
(ii) Intangible Assets — Goodwill			2,50,000
(2) Current Assets :			
(a) Inventories			6,00,000
(b) Trade Receivables — Debtors			6,75,000
(c) Cash and Cash Eqyuivalents — Cash at Bank			50,000
(d) Other Current Assets — Prepaid Expenses			10,000
TOTAL			20,35,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000
1,25,000 Equity Shares of ₹ 10 each, ₹ 4 paid-up	5,00,000
	15,00,000

Mr. Roy, a shareholders of Fortunate Ltd. holding 100 shares of ₹ 10 each and 50 shares of ₹ 4 each, wants to sell all the shares.

You are required to ascertain fair value of all shares held by Mr. Roy after considering the following information :

(a) Plant and Machinery of the company worth ₹ 3,00,000 and Debtors estimated to be worth ₹ 7,10,000.

(b) ₹ 15,000 creditors are outstanding for many years and it is estimated that the amount will not be payable and a disputed bonus claim shall have to be paid for ₹ 30,000.

(c) Divided paid for the last three years were 12%, 11% and 13% whereas normal rate of return is 10%.

(d) Goodwill is to be considered as average value of book value and 4 years' purchase of averge super profit for the last 3 years.

(e) Profits for the last 3 years were ₹ 1,05,000, ₹ 2,40,000 and ₹ 2,15,000.

Ignore Income Tax.

Solution

Calculation of Capital Employed

Particulars		₹
Sundry Assets :		
Plant and Machinery (as per valuation)		3,00,000
Inventories (as per Balance Sheet)		6,00,000
Debtors (Estimated)		7,10,000
Cash		50,000
Prepaid Expenses		10,000
	(A)	16,70,000
Liabilities :		
Creditors (1,50,000 – 15,000)		1,35,000
Bank Loan		1,50,000
Gratuity Payable		75,000
Disputed Bonus Claim		30,000
	(B)	3,90,000
Closing Capital Employed (A – B)		12,80,000

Computation of Super Profits

Particulars	₹
Average Profit of Last 3 Years (Note 4)	1,81,667
Less: Normal Return (10% of ₹ 11,80,000)	1,18,000
Super Profit	63,667

Valuation of Goodwill

4 Years' Purchase of Super Profit
= 4 x ₹ 63,667 = ₹ **2,54,667**

Calculation of Average Capital employed

Particulars	₹
Closing Capital employed (as calculated above)	12,80,000
Less: 1/2 of Adjusted Profit of Current Year (Note 3)	
[1/2 x (2,15,000 + 15,000 – 30,000)]	1,00,000
	11,80,000

Computation of Net Assets Available to Equity Shareholders

Particulars	₹
Closing Capital Employed	12,80,000
Add: Goodwill (as per valuation)	2,54,667
	15,34,667
Add: Notional Call (12,500 x ₹ 6) (Note 5)	7,50,000
Net Assets Available to Equity Shareholders	22,84,667

(a) Intrinsic Value of Each Equity Shares :

$$\text{Value of Each fully Paid Shares} = \frac{\text{Total Assets Available to Equity Shareholders}}{\text{Total Equity Shares}}$$

$$= \frac{22{,}84{,}667}{(1{,}00{,}000 + 1{,}25{,}000)} = \frac{22{,}84{,}667}{2{,}25{,}000} = ₹\ \mathbf{10.15}$$

Value of each Partly Paid Shares = ₹ 10.15 – ₹ 6 = ₹ **4.15**

(b) Earning Capacity Method :

Mr Roy is holding 100 fully paid-up shares and 50 partly paid-up shares. He is a minority shareholder. In this case, expected rate of dividend will be the average dividend paid by the company during last 3 years. Therefore, expected rate of dividend = (12% + 11% + 13%) / 3 = **12%**.

$$\text{Value per Share} = \frac{\text{Expected Rate of dividend}}{\text{Normal Rate of Return}} \times \text{Paid–up Value of Each Share}$$

(i) Fully paid Share's Value = $\frac{12\%}{10\%} \times ₹\ 10 = ₹\ \mathbf{12}$ (ii) Partly paid Share's Value = $\frac{12\%}{10\%} \times ₹\ 4 = ₹\ \mathbf{4.80}$

(c) Fair Value of Each Shares

Fair value of each equity share is the average of intrinsic value method and earning capacity method.

Fully paid Shares = $\frac{(10.15 + 12)}{2} = ₹\ 11.075$ Partly paid Shares = $\frac{(4.15+4.80)}{2} = ₹\ 4.48$

(d) Total Value of Shares held by Mr. Roy

100 fully paid shares = 11.075 × 100	1,108
50 Partly paid shares = 4.48 × 50	224
	1,332

Working Notes :

(1) Goodwill of the Balance Sheet is ignored because new value of goodwill has been calculated based on super profit method.

(2) Fixed assets has been revalued at ₹ 3,00,000. Therefore, depreciation fund is to be ignored.

(3) Adjusted Profit of the Current year :

	₹
Profit (as given)	2,15,000
Add: Discount received from Creditors	15,000
	2,30,000
Less: Disputed Bonus	30,000
	2,00,000

Current year's profit has been earned evenly throughout the year. Therefore, 1/2 of ₹ 2,00,000 was employed effectively in the business. At the time of calculating average capital employed, ₹ 1,00,000 is to be deducted from closing capital employed.

(4) Calculation of Average Profit of last 3 years :

	₹
1st year's profit	1,05,000
2nd year's profit	2,40,000
3rd year's profit (adjusted)	2,00,000 (Note 3)
	5,45,000

Average Profit = ₹ 5,45,000 / 3 = ₹ **1,81,667**.

(5) There are 1,25,000 partly paid shares (5,00,000 ÷ 4). The company will get ₹ 6 per share after final call. Therefore, net assets will be increased by ₹ 7,50,000 (1,25,000 × ₹ 6).

Total number of fully paid shares will be : 1,00,000 + 1,25,000 = **2,25,000 shares**.

Illustration 30

The Balance Sheet of Aspi Co. Ltd. as at 31.3.2016 is given below:

Balance Sheet of Aspi Co. Ltd. as at 31st March, 2016

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		(1)	20,00,000
(b) Reserves and Surplus — General Reserve		(2)	26,40,000
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors			1,92,000
TOTAL			48,32,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Building at Cost	3,20,000		
Less: Depreciation Fund	40,000		2,80,000
Furniture at Cost			12,000
(b) Non-current investments — 5% Government Security at cost	15,20,000		
Less: Depreciation Fund	1,80,000		13,40,000
(2) Current Assets :			
(a) Inventories — at market Price			17,00,000
(b) Trade Receivables — Sundry Debtors	13,00,000		
Less: Provision for Bad Debts	80,000		12,20,000
(c) Cash and Cash Equivalents — Cash at Bank			2,80,000
TOTAL			48,32,000

Notes to Accounts :

(1) Share Capital

Particulars		(₹)
Issued, Subscribed and Paid-up Capital :		
10,000 Equity Shares of ₹ 100 each fully paid		10,00,000
20,000 Equity Shares of ₹ 100 each, ₹ 50 paid-up		10,00,000
		20,00,000
(2) Reserve and Surplus		
General Reserve		6,00,000
Profit and Loss Account :		
Balance on 1.4.2015	15,20,000	
Add: Profit for 2015-16	5,20,000	20,40,000
		26,40,000

The following additional information is provided :

(a) It is ascertained that all the customers will pay in full;

(b) Profits for the past three years have shown an increase of ₹ 80,000 annually;

(c) The prospects for 2016 are equally good for the company;

(d) Buildings are worth ₹ 3,92,000 and Furniture ₹ 25,000;

(e) The companies carrying on similar business show a profit earning capacity of 12% on the market value of the shares.

You are required to ascertain the fair value of each share giving the details of your calculation.

Solution

Computation of Capital Employed

Particulars		₹
Sundry Assets :		
Building	3,92,000	
Furniture	25,000	
Inventories	17,00,000	
Debtors	13,00,000	
Bank	2,80,000	36,97,000
Less: Current Liabilities		
Sundry Creditors	1,92,000	
Income-tax Payable (Note 1)	2,60,000	4,52,000
Closing Trading Tangible Capital Employed		32,45,000
Less: $^1/_2$ of adjusted current year's profit after tax (Note 2) [$^1/_2$ x 50% x ₹ (5,20,000 – 76,000)]		1,11,000
Average Trading Tangible Capital Employed		31,34,000

Computation of Avg. Maintainable Super Profits

Particulars	₹
Average annual profit for the last 3 years (Note 3) ₹ (3,60,000 + 4,40,000 + 5,20,000) / 3	4,40,000
Less: Interest on investment (5% of ₹ 15,20,000)	76,000
	3,64,000
Less: Income-tax @ 50% (assumed)	1,82,000
	1,82,000
Less: Normal return on capital employed (12% on ₹ 31,34,000)	3,76,080
Average Annual Super Profit	(–) 1,94,080

The value of the goodwill is to be taken as nil, since the average annual super profit is negative.

Computation of Net Assets Available to Equity Shareholders

Particulars	₹
Closing trading tangible capital employed (as above)	32,45,000
Add: Investments in Govt. Securities	15,20,000
Add: Goodwill	Nil
Capital Employed by Equity Shareholders	47,65,000
Add: Notional calls (₹ 50 x 20,000)	10,00,000
Net Assets available to Equity Shareholders	57,65,000

(a) Intrinsic Value of Each Equity Share

$$\text{Fully paid shares} = \frac{\text{Total assets available to equity shareholders}}{\text{Total number of equity shares}} = \frac{57,65,000}{30,000} = ₹\ 192.17$$

Partly paid shares = ₹ 192.17 – ₹ 50.00 = ₹ 142.17

(b) Earning Capacity Method

Computation of Average Annual Profit Available to Equity Shareholders

Particulars	₹
Average annual profit for the last 3 years	4,40,000
Less: Income Tax @ 50%	2,20,000
	2,20,000
Less: Transfer to General Reserve (10% on ₹ 2,20,000)	22,000
Average Annual Profit available to Equity Shareholders	1,98,000

$$\text{Expected Rate of Dividend on Equity Share Capital} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid–up Value of each Equity Share.}$$

$$= \frac{1,98,000}{20,00,000} \times 100 = 9.9\% \qquad \text{Fully paid share} = \frac{9.9\%}{12\%} \times 100 = ₹\ 82.50. \qquad \text{Partly paid share} = \frac{9.9\%}{12\%} \times 50 = ₹\ 41.25.$$

(c) Fair Value Method

Fair value of each equity share is the average of intrinsic value and yield value.

Fully paid share = (₹ 192.17 + ₹ 82.50) / 2 = ₹ 137.33 **Partly paid share** = (₹ 142.17 + ₹ 41.25) / 2 = ₹ 91.71

Working Notes :

(1) Income tax @ 50% (assumed) is payable on income of 2015.

(2) For calculating average capital employed, 50% of current year's trading profit (after tax) is to be deducted. Here, ₹ 76,000 represents income from investment in government securities.

(3) Profit for 2015 is ₹ 5,20,000 which is higher than the profit of 2014 by ₹ 80,000. Therefore, the profit of 2014 is ₹ 5,20,000 – ₹ 80,000 = ₹ 4,40,000. Similarly, the profit of 2013 is ₹ 3,60,000 (₹ 4,40,000 – ₹ 80,000).

Illustration 31

The Balance Sheet of ABC Ltd. as at 31st March, 2016 was as follows :

Balance Sheet of ABC Ltd. as at 31st March, 2016

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 50,000 Equity Shares of ₹ 10 each			5,00,000
(b) Reserves and Surplus — General Reserve			2,25,000
Profit and Loss Account			1,00,000
Staff Welfare fund			40,000
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 12% Debentures			3,00,000
(4) Current Liabilities :			
(a) Trade Payables — Creditors			1,85,000
(b) Short-term Provisions — Proposed Dividend			75,000
TOTAL			14,25,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Equipment at Cost	9,00,000		
Less: Provision for Depreciation	1,50,000		7,50,000
(ii) Intangible Assets — Goodwill			1,00,000
(2) Current Assets :			
(a) Inventories			3,50,000
(b) Trade Receivables — Debtors			1,50,000
(c) Cash and Cash Equivalents — Cash at Bank			75,000
TOTAL			14,25,000

You are required to calculate the value of each equity share on assets basis based on the following information :

(i) A fair after-tax return on capital employed for this type of business is 18%.
(ii) Equipment to be revalued at ₹ 8,00,000.
(iii) Inventoriess are considered to have a net realisable value of ₹ 3,30,000.
(iv) Goodwill in this type of business is normally valued at 3 years' super profits.
(v) Included in the debtors is a balance of ₹ 10,000 which may be irrecoverable.
(vi) Profits for the last three years (before interest and taxes) are: 2015-16 — ₹ 5,40,000; 2014-15 — ₹ 5,10,000; 2013-2014 — ₹ 5,50,000.
(vii) Company profits are taxed at 40%.

Solution

Computation of Capital Employed

Particulars		₹
Sundry Assets :		
Equipment	8,00,000	
Inventories		
3,30,000		
Debtors less provision ₹ (1,50,000 – 10,000)	1,40,000	
Bank	75,000	13,45,000
Less: Current Liabilities		
Sundry Creditors	1,85,000	
Proposed Dividend	75,000	2,60,000
Trading Tangible Capital Employed		10,85,000

Computation of Avg. Maintainable Super Profits

Particulars	₹
Average annual profit for the last 3 years before interest and taxes ₹ (5,10,000 + 5,10,000 + 5,50,000) / 3	5,23,333
Less: Income tax @ 40%	2,09,333
	3,14,000
Less: Normal return on capital employed (18% on ₹ 10,85,000)	1,95,300
Average Annual Super Profit	1,18,700

Goodwill is the value of 3 years' average annual maintainable super profits = 3 x ₹ 1,18,700 = ₹ 3,56,100.

Computation of Net Assets Available to Equity Shareholders

Particulars	₹
Trading tangible capital employed (as above)	10,85,000
Add: Goodwill (as above)	3,56,100
Total Assets	14,41,100
Less: 12% Debentures	3,00,000
Net Assets available to Equity Shareholders	11,41,100

Value of each Equity Share on Net Assets Basis

$$\text{(i) Ex-dividend} = \frac{\text{Net Assets available to Equity Shareholders}}{\text{Number of Equity Shares}} = \frac{11{,}41{,}100}{50{,}000} = ₹\ 22.82$$

$$\text{(ii)Cum-dividend} = \frac{\text{Net Assets available Equity Shareholders + Proposed Dividend}}{\text{Number of Equity Shares}} = \frac{11{,}41{,}100 + 75{,}000}{50{,}000} = ₹\ 24.32$$

Working Notes :

(i) Staff welfare fund is an appropriation of profits and not an outside liability.

(ii) 12% debentures are assumed to be issued for a long period and, hence considered as a part of capital employed.

(iii) Profit for 2015-16 is calculated as under :

	₹	₹
Profit (as given)		5,40,000
Less: Decrease in the value of stock (₹ 3,50,000 – ₹ 3,30,000)	20,000	
Provision for bad debts	10,000	30,000
		5,10,000

Illustration 32

The Balance Sheet of Sunshine Ltd. as on 31st March, 2016 was as follows :

Balance Sheet of Sunshine Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus — General Reserve		69,000
Profit and Loss Account		90,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		10,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		1,26,000
TOTAL		7,95,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		
Land and Building		2,20,000
Plant and Machinery		2,00,000
(ii) Intangible Assets — Goodwill		30,000
(2) Current Assets :		
(a) Inventories		2,10,000
(b) Trade Receivables — Debtors		60,000
(c) Cash and Cash Equivalents — Cash at Bank		75,000
TOTAL		7,95,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
2,000 Equity Shares of ₹ 100 each fully paid	2,00,000
2,000 Equity Shares of ₹ 100 each, ₹ 50 per share paid	1,00,000
2,000, 6% Preference Shares of ₹ 100 each fully paid	2,00,000
	5,00,000

The following further information is available :

(i) Land and Buildings and Machinery were revalued at ₹ 3,00,000 and ₹ 1,70,000 respectively.

(ii) Normal return on capital employed for valuation of goodwill is 10%. Apart from this, depreciation to be charged on the revalued assets which are on Land and buildings @ 5% and on machinery @ 10%. Average profit of the last 3 years was ₹ 1,00,500 (after deduction of tax @ 50%). The basis of valuation of goodwill is 3 years' purchase of super profits. Preference share dividend of ₹ 12,000 was in arrear which was included in sundry creditors. Similar companies are paying 10% dividend on equity share.

Find out the value of equity shares both on :

(a) Asset Backing Method and

(b) Yield Method.

Solution

(i) Asset Backing Method of Valuation

Computation of Capital Employed

Particulars		₹
Sundry Assets :		
Land and Buildings	3,00,000	
Machinery	1,70,000	
Inventories	2,10,000	
Debtors	60,000	
Cash at Bank	75,000	8,15,000
Less: Current Liabilities		
Sundry Creditors (₹ 1,26,000 – 12,000)	1,14,000	
Arrear Preference Dividend	12,000	1,26,000
Average Trading Tangible Capital Employed		6,89,000

Computation of Avg. Maintainable Super Profits

Particulars	₹
Average annual profit for the last 3 years before taxation ₹ (1,00,500 x 100 / 50)	2,01,000
Add: Depreciation overcharged on decrease in the value of machinery (10% on ₹ 30,000)	3,000
	2,04,000
Less: Depreciation undercharged on increase in the value of land and buildings (5% on ₹ 80,000)	4,000
	2,00,000
Less: Income Tax @ 50%	1,00,000
Adjusted Annual Average Profit after Tax	1,00,000
Add: Interest on Debenture (5% on ₹ 10,000)	500
	1,00,500
Less: Normal return on capital emp. (10% on ₹ 6,89,000)	68,900
Average Annual Maintainable Super Profit	31,600

Value of goodwill is the 3 years' purchase of super profits = ₹ 31,600 x 3 = ₹ 94,800.

Computation of Net Assets Available to Equity Shareholders

Particulars	₹
Average trading tangible capital employed (as above)	6,89,000
Add: Goodwill (as above)	94,800
	7,83,800
Less: Long-term liabilities — 5% Debentures	10,000
Net assets available to equity and preference shareholders	7,73,800
Less: Preference share capital	2,00,000
	5,73,800
Add: Notional calls on partly paid-up equity shares (₹ 50 x 2,000)	1,00,000
Net Assets available to Equity Shareholders	6,73,800

Value of Equity Shares under Asset Backing Method

$$\text{Value of each Fully Paid Share} = \frac{\text{Net Assets available to Equity Shareholders}}{\text{Total Number of Equity Shares}} = \frac{6{,}73{,}800}{2{,}000 + 2{,}000} = ₹\ 168.45$$

Value of each partly paid-up equity share = ₹ 168.45 – ₹ 50.00 = ₹ 118.45.

(ii) Yield Method of Valuation

Computation of Average Annual Profit Available to Equity Shareholders

Particulars	₹
Adjusted annual average profit after tax (as above)	1,00,000
Less: Transfer to reserves 10% (assumed)	10,000
Net profit available to equity and preference shareholders	90,000
Less: Preference share dividend (6% on ₹ 2,00,000)	12,000
Average Annual Profit available to Equity Shareholders	78,000

Therefore, available rate of dividend on equity share capital :

$$\frac{\text{Average Annual Profit available to Equity Shareholders}}{\text{Paid–up Equity Share Capital}} \times 100 = \frac{78{,}000}{3{,}00{,}000} \times 100 = 26\%.$$

Value of Equity Shares under yield method :

$$\text{Value of each Fully Paid Share} = \frac{\text{Available Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid–up Value of a Share} = \frac{26\%}{10\%} \times \text{Rs } 100 = \text{Rs } 260$$

$$\text{Value of each Partly paid–up Share} = \frac{26\%}{10\%} \times \text{Rs } 50 = \text{Rs } 130.$$

Tutorial Notes :

(i) 5% Debentures are considered as a part of capital-employed with the assumption that these are issued for a long period.

(ii) Arrear preference dividend is considered as a contingent liability (in fact, it is) and, therefore, not deducted from net assets available to equity and preference shareholders.

Illustration 33

The Rising Sun Co. Ltd. has an issued, subscribed and paid-up share capital comprising 5,000 equity shares of ₹ 100 each and 1,500, 9% preference shares of ₹ 100 each. The following information is supplied :

Year	Average Net worth (Excluding Investments) (₹)	Adjusted Taxed Profits (₹)
2013	9,30,000	95,000
2014	10,75,000	1,05,000
2015	10,95,000	1,25,000

As at the valuation date, the company has investment of the market value of ₹ 1,40,000 the yield in respect of which has been excluded in arriving at adjust taxed profits figures.

The company sets apart 25% of taxed profits as rehabilitation and replacement reserve.

On the valuation date networth (excluding investments) amounts to ₹ 11,25,000. The expected rate of return in the market is 9%. The company has consistently maintained dividend levels of 8% to 10% in the past and is known for its consistency.

Ascertain the value of each equity share on the basis of productivity, applying suitable weighted averages.

Solution

The company has consistently maintained dividend levels of 8% to 10% in the last three years and is known for its consistentcy. Since the value of each share is to be calculated on the basis of productivity, it involves determining the earning capacity. The past results show a clearly increasing trend and, therefore, profits are to be weighted 1 : 2 : 3 — the greatest weight being given in the last year.

(a) Calculation of Rate of Earnings

Year	Average Net worth (₹)	Adjusted Taxed Profits (₹)	Rate of Earnings (₹)	Weights	Weighted Rate of Earnings
2013	9,30,000	95,000	95,000 / 9,30,000 x 100 = 10.215%	1	10.215
2014	10,75,000	1,05,000	1,05,000 / 10,75,000 x 100 = 9.767%	2	19.534
2015	10,95,000	1,25,000	1,25,000 / 10,95,000 x 100 = 11.416%	3	34.248
				6	63.997

Therefore, weighted average rate of earnings = 63.997 / 6 = 10.67%

(b) Computation of Average Annual Profit Available to Equity Shareholders

Particulars		₹
Average maintainable profits, i.e., 10.67% on ₹ 11,25,000		1,20,000
Less: Depreciation and replacement reserve @ 25% on ₹ 1,20,000	30,000	
Preference dividend @ 9% on ₹ 1,50,000	13,500	43,500
Average Annual Profit available to Equity Shareholders (excluding income on investment)		76,500

(c) Ascertainment of Capitalised Net worth

Particulars	₹
Capitalised value at the expected rate of return : ₹ 76,500 / 0.09	8,50,000
Add : Total value of investments	1,40,000
Net Assets available to Equity Shareholders (excluding income on investment)	9,90,000

(d) Value of each equity share = ₹ 9,90,000 / 5,000 = ₹ 198.

Illustration 34

From the information supplied below, compute the value of an equity share of Haldia Ltd. on the "Assets-Backing Method":

(i) The summarised Balance Sheet of Haldia Ltd. (a manufacturing concern) as on 31.3.2016 :

Balance Sheet of Haldia Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,60,000
(b) Reserves and Surplus — General Reserve		1,20,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 600, 9% Debentures of ₹ 100 each		60,000
(4) Current Liabilities :		
(b) Trade Payables — Sundry Creditors		60,000
TOTAL		9,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		2,40,000
Plant and Machinery		2,40,000
(b) Non-current investments — 10% Government Securities		60,000
(2) Current Assets :		
(a) Inventories		1,20,000
(b) Trade Receivables — Sundry Debtors		30,000
(c) Cash and Cash Equivalents — Cash at Bank		2,10,00
TOTAL		9,00,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
6,000 Equity Shares of ₹ 100 each fully paid	6,00,000
600, 10% Preference Shares of ₹ 100 each fully paid	60,000
	6,60,000

(ii) Fair return on capital employed in this type of business is around 10% p.a.

(iii) Goodwill is to be taken at 5 years' purchase of super profits.

(iv) Average of the profits for the last seven years is ₹ 1,20,000. Profit is more or less stable over years and the same trend is expected to be maintained in the near future. Ignore tax.

Solution

Computation of Capital Employed

Particulars		₹
Sundry Assets :		
Land and Buildings	2,40,000	
Plant and Machinery	2,40,000	
Sundry Debtors	30,000	
Inventories	1,20,000	
Cash at Bank	2,10,000	8,40,000
Less: Current Liabilities		
Sundry Creditors		60,000
Average Trading Tangible Capital Employed		7,80,000

Computation of Avg. Maintainable Super Profits

Particulars	₹
Average annual profit for the last seven years	1,20,000
Less: Interest on investment (10% on ₹ 60,000)	6,000
	1,14,000
Add: Interest on Debentures (9% on ₹ 60,000)	5,400
	1,19,400
Less: Normal return on capital emp. (10% on ₹7,80,000)	78,000
Average Annual Super Profit	41,400

Goodwill is valued at 5 years' purchase of average annual super profits = 5 x ₹ 41,400 = ₹ **2,07,000.**

Computation of Net Assets Available to Equity Shareholders

Particulars	₹
Trading tangible capital employed (as above)	7,80,000
Add: Goodwill (as above)	2,07,000
Investments	60,000
Gross Capital Employed	10,47,000
Less: 9% Debentures	60,000
Net assets available to equity and preference shareholders	9,87,000
Less: 10% Preference share capital	60,000
Net Assets available to Equity Shareholders	9,27,000

Value of Shares under Asset Backing Method :

$$\text{Value of each Fully Paid Share} = \frac{\text{Value of Net Assets available to Equity Shares}}{\text{Number of Equity Shares}} = \frac{9{,}27{,}000}{6{,}000} = ₹\ 154.40$$

Tutorial Notes :

(i) Investment in government securities is a marketable security and, therefore, is a non-trading asset.

(ii) Debentures are assumed to be issued for a long period and, hence taken as a part of capital employed.

Illustration 35

Balance Sheet of Diamond Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 2,000 Equity Shares of ₹ 100 each		2,00,000
(b) Reserves and Surplus — General Reserve		1,00,000
Profit and Loss Account		20,000
(2) Share Application Money Pending Allotment		—

(3) Non-current Liabilities		—
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		1,28,000
TOTAL		4,48,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		1,10,000
Plant and Machinery		1,30,000
(ii) Intangible assets — Patent and Trademarks		20,000
(2) Current Assets :		
(a) Inventories		48,000
(b) Trade Receivables — Debtors		88,000
(c) Cash and Cash Equivalents — Bank Balance		52,000
TOTAL		4,48,000

The expert valuer valued the land and buildings at ₹ 2,40,000; goodwill at ₹ 1,60,000; and plant and machinery at ₹ 1,20,000. Out of the total debtors, it is found that debtors of ₹ 8,000 are bad. The profits of the company have been as follows : 2013-14 — ₹ 80,000; 2014-15 — ₹ 90,000; 2015-16 — ₹ 1,06,000.

Rate of depreciation on plant and machinery @ 15% and on land and building @ 10%.

The company follows the practice of transferring 25% of profits to general reserve. Similar type of companies earn at 10% of the value of their shares. Ascertain the value of shares of the company under :

(i) intrinsic value method; (ii) yield value method; and

(iii) fair value method

Ignore taxation.

Solution **Valuation of Shares of Diamond Ltd.**

(i) Intrinsic Value Method	₹	(ii) Yield Value Method	₹
Sundry Assets :		Total profits of last three years	2,76,000
Land and Buildings	2,40,000	Less: Bad Debts	8,000
Goodwill	1,60,000		2,68,000
Plant and Machinery	1,20,000	Average Profit (₹ 2,68,000 / 3)	89,333
Patent and Trademarks	20,000	Add: Reduction in depreciation :	
Inventories	48,000	on Plant and Machinery @ 15% on ₹ 10,000	1,500
Debtors *less* Bad Debts	80,000	Less: Additional depreciation on land and building	
Bank Balance	52,000	@ 10% on ₹ 1,30,000	(13,000)
	7,20,000	**Average Maintainable Profit**	77,833
Less: Sundry Creditors	1,28,000	Less: Transfer to Reserve @ 25% on ₹ 77,833	19,458
Net Assets	5,92,000	Profit available for Dividend	58,375
Number of Shares	2,000		
Value of each share (₹ 5,92,000 / 2,000)	₹ 296		

(i) Expected Rate of Dividend

$$\frac{\text{Profit available for Dividend}}{\text{Share Capital}} \times 100 = \frac{58{,}375}{2{,}00{,}000} \times 100 = 29.187\%$$

(ii) Yield Value of Each Share

$$\frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid–up Value of Each Share} = \frac{29.187\%}{10\%} \times \text{Rs } 100 = \text{Rs } 291.87$$

(iii) Fair Value Method

$$\text{Fair value of each share} = \frac{\text{Intrinsic value} + \text{Yield value}}{2} = \frac{296 + 291.87}{2} = ₹\ 293.94$$

Tutorial Note :

(i) Preliminary expenses is a fictitious asset. Therefore, it should be ignored for calculating net assets.

(ii) Income tax reserve is not a liability. Therefore, it should not be deducted for calculating net assets.

Illustration 36

Following information is furnished in respect of Sahana Fibres Ltd.

(1) Share capital : 2,00,000 equity shares of ₹ 10 each fully paid.

(2) Profits after tax, dividends declared and retained earnings :

Year	Profit after tax (₹)	Dividend declared (₹)	Retained earnings (₹)
2015	7,10,000	3,40,000	3,70,000
2014	6,00,000	3,00,000	3,00,000
2013	4,00,000	2,60,000	1,40,000

(3) Normal rate of return expected by shareholders in the market is 12%.

(4) The normal earnings of similar companies in the fibre industry is 15%.

You are required to calculate the value of shares if —

(a) only a few shares are to be sold; and,

(b) majority shares are to be sold.

Solution

(a) The Company has consistently maintained a growing trend from 2013 to 2015, profits are to be weighted in the ratio of 1 : 2 : 3 — the greatest weight being given in the last year.

Since only a few shares are to be sold, the shares should be valued on the basis of dividend declared and expected normal rate of return.

Year	Dividends Declared (₹)	Share Capital (₹)	Rate of Dividend (₹)	Weights	Weighted Dividend Rates
2013	2,60,000	20,00,000	(2,60,000 / 20,00,000) x 100 = 13%	1	13
2014	3,00,000	20,00,000	(3,00,000 / 20,00,000) x 100 = 15%	2	30
2015	3,40,000	20,00,000	(3,40,000 / 20,00,000) x 100 = 17%	3	51
				6	94

Weighted average rate of dividend ratio = 94 / 6 = 15.67%.

Therefore, yield value of each equity share :

$$\frac{\text{Weighted Average Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid–up Value of each Equity Share} = \frac{15.67}{12} \times 10 = \text{Rs } 13.06$$

(b) When majority shares are to be sold, the share should be valued on the basis of weighted average profits of the business and expected normal earnings of similar companies in the same industry.

Calculation of Weighted Earnings

Year	Earnings (₹)	Weights (₹)	Weighted Earnings	
2013	4,00,000	1	4,00,000	Therefore, **Weighted Average Earnings** = ₹ 37,30,000 / 6 = ₹ 6,21,667
2014	6,00,000	2	12,00,000	**Weighted Average Rate of Earnings** = ₹ 6,21,667 / 20,00,000 x 100 = 31% (approx.)
2015	7,10,000	3	21,30,000	**Value of each Equity Share**
		6	37,30,000	= { Weighted average rate of earnings / Normal return } x Paid-up value of each share = (31 / 15) x 10 = ₹ 20.67

Illustration 37

Following is the Balance Sheet of Alpha Ltd. as at 31st December, 2015 :

Balance Sheet of Alpha Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	9,00,000
(b) Reserves and Surplus — General Reserve		3,30,000
Profit and Loss Account		2,50,000
(2) Share Application Money Pending Allotment		—
(3) Non-current Liabilities		—
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		5,00,000
TOTAL		19,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		
Land and Building		4,00,000
Machinery		4,50,000
Motor Car		25,000
Furniture		25,000
(ii) Non-current Investments		50,000
(2) Current Assets :		
(a) Inventories		7,25,000
(b) Trade Receivables — Sundry Debtors		2,00,000
(c) Cash and Cash Equivalents — Cash at Bank		1,05,000
TOTAL		19,80,000

Additional information is as under :

(i) Fixed assets are worth :
Building — ₹ 6,00,000; Machinery — ₹ 5,20,000.

(ii) All investments are non-trading investments and are to be valued at 20% above cost. Dividend at uniform rate of 20% is earned on all investments.

(iii) For the purpose of valuation of shares, goodwill is to be valued on the basis of 3 years purchase of super profits based on average profit (after tax) of the last three years.

(iv) Depreciation on appreciated value of Land & Building and Machinery is not to be considered for valuation of goodwill.

(v) Profit (after tax) are as follows :
2013 — ₹ 3,80,000; 2014 — ₹ 4,20,000; 2015 — ₹ 5,00,000.
Rate of income tax : 50%. In similar business, return on capital employed is 20% (after tax).

(vi) In 2013 machinery (book value ₹ 20,000) was sold for ₹ 20,000 but the proceeds were wrongly credited to Profit and Loss Account. The mistake has not yet been rectified. Depreciation has been charged on machinery @ 10% per annum on reducing balance method.

Find out the value of each fully paid and partly paid equity share on net assets basis.
(**Note :** Trend in profit is to be ignored for the purpose of calculation of average profit).

Solution

Working Notes : (1) Average Maintainable Trading Profit

Particulars	2013 (₹)	2014 (₹)	2015 (₹)
Profit after tax	3,80,000	4,20,000	5,00,000
Less: Sale proceeds of machinery wrongly credited to Profit and Loss Account (Net of tax)	10,000		
	3,70,000		
Less: Dividend on non-trading investment (Net of tax)	5,000	5,000	5,000
	3,65,000	4,15,000	4,95,000
Add: Depreciation wrongly charged on assets sold (Net of tax) — 50% of ₹ 2,000; 1,800 and ₹ 1,620	1,000	900	810
	3,66,000	4,15,900	4,95,810
Average Profit (₹ 3,66,000 + ₹ 4,15,900 + ₹ 4,95,810) / 3 = ₹ 4,25,903; say, ₹ **4,25,900**			

(2) Computation of Capital Employed

Particulars	₹
Sundry Assets :	
Land and Building	6,00,000
Machinery	5,20,000
Motor Car	25,000
Furniture	25,000
Inventories	7,25,000
Debtors	2,00,000
Cash	1,05,000
	22,00,000
Less: Creditors	5,00,000
	17,00,000

(3) Calculation of Super Profits

Particulars	₹
Average Maintainable Trading Profit (as above)	4,25,900
Less: Normal Profit @ 20% on ₹ 17,00,000	3,40,000
Super Profits	85,900
Therefore, Goodwill = 3 x ₹ 85,900 = ₹ **2,57,700.**	

Valuation of Shares on Net Assets Basis

Particulars	₹
Value of Goodwill (Note 3)	2,57,700
Capital Employed (Note 2)	17,00,000
Non-trading Investments (₹ 50,000 / 100 x 120)	60,000
Notional Call on shares	1,00,000
	21,17,700

Value of a fully paid-up share = $\frac{21,17,700}{10,000}$ = ₹ **211.77.** Value of a partly paid-up share = ₹ 211.77 – ₹ 20 = ₹ **191.77**.

KEY POINTS

- ***Lord Lindley defines goodwill as follows :*** *"The term goodwill can hardly be said to have any precise significance. It is generally used to denote the benefit arising from connection and reputation and its value is what can be got for the change of being able to keep that connection and improve it. Upon the sale of an established business its goodwill has a marketable value, whether the business is that of a professional man or of any other person. But it is plain that goodwill has no meaning except in connection with a continuing business, and the value of the goodwill of any business to a purchaser depends in some cases entirely, and in all very much, on the absence of competition on the part of those by whom the business has been previously carried on".*
- **Distinguishing Features of Goodwill**

  Goodwill is different from any other type of assets since it is the earning power of the business. Following are the factors distinguishing goodwill from most other assets :

  (a) It represents a non-physical value over and above the physical assets.

  (b) It cannot have an existence separate from the business and, therefore, cannot be realised separately.

  (c) It is difficult to place a cost on goodwill as the value may fluctuate from day-to-day as a result of internal and external circumstances, i.e., changing fortunes of the company's business.

  (d) The amount or value of the goodwill and the assessment of its actual existence is highly dependent on the subjective judgment of the valuer.

KEY POINTS (contd...)

- **Positive and Negative Goodwill** : Since goodwill is the difference between the value of a business as a whole and the fair value of its separate net assets, goodwill can be both positive and negative. Non-purchased goodwill exists in all businesses. Positive goodwill arises when the value of the business as a whole is more than the fair value of the separate net assets. If the real worth of the business is less than the sum of the fair values of the separate net assets, it represents negative goodwill.
- Super profit is the excess of actual profit over the normal profit of an enterprise. A common method of valuation of goodwill is the super-profit method. A business unit may possess some advantages which enable it to make extra profits over and above the amount that would be earned if the capital of the business was invested elsewhere with similar risks. These extra profits, generally expressed as super profits, can be valued, and goodwill is the value of the few years' purchase of super profit.
- **Factors Affecting Valuation of Shares** :
  (1) The nature of the company's business.
  (2) Percentage of dividend declared on the shares.
  (3) The demand and supply of shares.
  (4) The income yielding capacity of the company.
  (5) The availability of sufficient assets over liabilities.
  (6) General economic conditions, e.g., availability of raw materials, possibility of new competition.
  (7) Financial, political and other factors affecting the business.
  (8) The fact that there is no free market for unquoted shares.
- There are two widely applied methods for the valuation of shares : (a) The Assets Backing Method; and (b) The Yield Valuation Method.

THEORETICAL QUESTIONS

1. What is Goodwill ? What are the distinguishing features of Goodwill ?
2. What are the important features of 'purchased' and 'non-purchased' Goodwill ?
3. State the important factors to be taken into consideration in valuing Goodwill ?
4. State the methods of accounting for Goodwill.
5. What is super profit ? What are the steps to be followed for calculating super profit for the valuation of Goodwill ?
6. What is the distinction between "Capitalisation of Super Profit Method" and "Annuity Method" for valuing Goodwill?
7. What are the important points to be taken into consideration in determining the profits upon the basis of which Goodwill is to be valued ?
8. What is the need for valuation of shares ? State the factors affecting valuation of shares.
9. State the two widely applied methods for the valuation of shares.
10. What is the difference between "Asset Backing Method" and "Yield Valuation Method" for valuing the shares.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Goodwill is the outcome of an impression created in the mind of each
   A customer
   B creditor
   C none of these
2. Dog goodwill is
   A valuable
   B less valuable
   C none of these
3. Price paid for goodwill depends upon the purchaer's expectation of future
   A growth
   B profits
   C none of these

4. The figure computed as goodwill
   A is an exact one
   B cannot be an exact one
   C none of these.
5. Goodwill may be valued on the basis of
   A actual profits
   B super profitsl
   C none of these

PRACTICAL QUESTIONS

Valuation of Goodwill

1. The net profit of a business, after providing for taxation, for the past five years are : ₹ 80,000; ₹ 85,000; ₹ 92,000; ₹ 1,05,000 and ₹ 1,18,000. The capital employed in the business is ₹ 8,00,000. The normal rate of return expected in this type of business is 10%. It is expected that the company will be able to maintain the super profit for the next 5 years. Calculate the value of goodwill on the basis of :
   (a) 5 years' purchase of super profit method,
   (b) Annuity method, taking the present value of annuity of ₹ 1 for five years at 10% as 3.78 and
   (c) Capitalisation of super profit method.
2. The profit of ABC Ltd. for the last 6 years were as follows :
   2010—₹ 12,000; 2011—₹ 15,000; 2012—₹ 16,000; 2013—₹ 20,000; 2014—₹ 14,000; 2015—₹ 25,000.
   Compute the value of goodwill of ABC Ltd. on the basis of 5 years' purchase of weighted average profit after assigning weights 1,2,3,4,5 and 6 serially to the profits.
3. PQR Co. Ltd. intends to purchase the business of ABC Co. Ltd. Goodwill for their purpose is agreed to be valued at 3 years' purchase of the weighted average profits of the past four years. The appropriate weights to be used :
   2012 — 1, 2013 — 2, 2014 — 3 and 2015 — 4.
   The profits for these years were : 2012 — ₹ 30,900; 2013 — ₹ 45,400; 2014 — ₹ 35,700; 2015 — ₹ 48,000.
   The following information were available :
   (i) On 1.9.2013, a major repair was made in respect of a plant at a cost of ₹ 8,000 and this was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on diminishing balance method.
   (ii) The closing stock for the year 2014 was overvalued by ₹ 3,000.
   (iii) To cover the management cost an annual charge of ₹ 10,000 should be made for the purpose of goodwill.
   You are asked to compute the value of goodwill of the company.
4. Hammer Ltd. and Grace Ltd. propose to amalgamate. The Balance Sheets of Hammer Ltd. and Grace Ltd. as on 31st December, 2015 are given below :

Balance Sheets of Hammer Ltd. and Grace Ltd. as at 31st December, 2015

Particulars	Note No.	Hammer Ltd. (₹)	Grace Ltd. (₹)
(1)	(2)	(3)	
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		5,00,000	2,00,000
(b) Reserves and Surplus — General Reserve		2,00,000	20,000
Profit and Loss Account		1,00,000	30,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables		1,00,000	50,000
TOTAL		9,00,000	3,00,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		4,00,000	1,00,000
(b) Non-current investments — 6% G/P/ Notes (Face Value ₹ 1,00,000)		1,00,000	—
(2) Current Assets :			
(a) Other Current Assets		4,00,000	2,00,000
TOTAL		9,00,000	3,00,000

Net profit (after taxation) :
Hammer Ltd. — 2013 : ₹ 1,30,000; 2014 : ₹ 1,25,000; 2015 : ₹ 1,50,000.
Grace Ltd. — 2013 : ₹ 45,000; 2014 : ₹ 40,000; 2015 : ₹ 56,000.
Goodwill for the purposes of amalgamation may be taken at 4 years' purchase of average super-profits (trading) on the basis of 15% normal profit on closing capital ivested. The current assets of Hammer Ltd. are to be taken as ₹ 4,20,000 and that of Grace Ltd. is ₹ 2,10,000.
Ascertain the value of goodwill.

5. The net profit of a company after providing for taxation for the past five years are :
₹ 20,000; ₹ 25,000; ₹ 15,000; ₹ 35,000 and ₹ 40,000. The net tangible assets in the business is ₹ 2,00,000 on which the normal rate of return is expected to be 10%. It is also expected that the company will be able to maintain its super profits for the next five years.
Calculate the value of goodwill of the business on the basis of an annuity of super profits, taking the present value of an annuity of one rupee for five years at 10% interest is ₹ 3.78.

6. The Balance Sheet of ABC Co. Ltd. discloses the following financial position as at 31.12.2015 :

Balance Sheet of ABC Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(')	2,00,000
(b) Reserves and Surplus — General Reserve		10,000
Unappropriated Profits		40,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 7% Mortgage Debentures		5,00,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		4,00,000
TOTAL		11,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,50,000
Land and Building		4,00,000
Plant and Machinery		
(2) Current Assets :		
(a) Inventories		2,00,000
(b) Trade Receivables — Book Debts		1,50,000
(c) Cash and Cash Equivalents — Cash at Bank		50,000
TOTAL		11,50,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 100 each fully paid	1,00,000
10,000, 8% Preference Shares of ₹ 100 each fully paid	1,00,000
	2,00,000

You are asked to value the Goodwill of ABC Co. Ltd. for which purpose the following information is supplied :

(i) Adequate provision has been made in the accounts for income-tax etc.

(ii) The assets of the company have been adequately depreciated.

(iii) Plant and Machinery of ₹ 4,00,000 is shown after charging adequate depreciation. The present market value of plant and machinery is ₹ 5,00,000.

(iv) Given below are figures of profits and losses (after charging depreciation) and sale from first year to 2015 :

	2009	2010	2011	2012	2013	2014	2015
Profits :	1,40,000	1,10,000	– 1,20,000	40,000	1,00,000	1,50,000	1,70,000
Sales	11,00,000	12,00,000	9,00,000	6,00,000	12,00,000	14,00,000	17,50,000

The reasonable rate of return on capital invested, in the class of business done by ABC Co. Ltd. is 10%.

It may be assumed that the company will be able to maintain its profits for the next few years on the same level as for the previous years.

The loss in 2011 was due to special circumstances.

You may assume any further facts necessary.

7. The following is the Balance Sheet of Mr. X as on 31.12.2015 :

Liabilities	₹	Assets	₹
Capital	1,64,000	Land and Building	36,000
General Reserve	40,000	Plant	54,500
Creditors	38,040	Investment	30,000
		Inventories	26,350
		Bank	75,990
		Debtors	19,200
	2,42,040		2,42,040

The following were the net profits for the year ended : 2013 : ₹ 32,280; 2014 : ₹ 36,870; 2015 : ₹ 43,350.

The above amounts include income from investment, ₹ 1,800 each year.

You are required to value the Goodwill of the above business at 2 years' purchase of the average super profit for 3 years, taking into account the fact that the standard rate of return on capital employed in such type of business is 10% and assuming that each year's profit is immediately withdrawn in full by Mr. X.

8. From the following Balance Sheet (as at 31st December), compute the goodwill of the firm XYZ Co. Ltd. on the basis of four year's purchase of the average super profits on a 10% yield basis.

Balance Sheet of XYZ Co. Ltd. as at 31st December, 2015

Particulars	Note No.	2013 (₹)	2014 (₹)	2015 (₹)
(1)	(2)			(3)
I. EQUITY AND LIABILITIES				
(1) Shareholders' Funds :				
(a) Share Capital — 10,000 Equity Shares of ₹ 100 each fully paid		10,00,000	10,00,000	10,00,000
(b) Reserves and Surplus — General Reserve		5,00,000	6,00,000	7,00,000
Profit and Loss Account		70,000	80,000	1,20,000
(2) Share Application Money Pending Allotment :		—	—	—
(3) Non-current Liabilities :		—	—	—
(4) Current Liabilities :				
(a) Trade Payables — Sundry Creditors		3,00,000	4,00,000	5,00,000
TOTAL		18,70,000	20,80,000	23,20,000

II. ASSETS				
(1) Non-current Assets :				
(a) Fixed Assets				
(i) Tangible Assets :				
Building and Machinery (Less Depreciation)		9,00,000	10,00,000	10,00,000
(ii) Intangible Assets — Goodwill		5,00,000	4,00,000	3,00,000
(2) Current Assets :				
(a) Inventories		4,00,000	5,00,000	6,00,000
(b) Trade Receivables — Debtors		10,000	80,000	2,20,000
(c) Cash and Cash Equivalents — Cash at Bank		60,000	1,00,000	2,00,000
TOTAL		18,70,000	20,80,000	23,20,000

The following assets had been undervalued, their real worth to the business being :

Assets	2013 (₹)	2014 (₹)	2015 (₹)
Building and Machinery	10,00,000	11,00,000	12,00,000
Inventories	6,00,000	7,00,000	8,00,000
Net Profit — after writing-off depreciation and making provisions for Taxation and General Reserve (including opening balance)	4,10,000	5,10,000	6,10,000

As per the Articles of Association of this private company, its Directors have declared and paid dividends to its members to its members in the month of December, each year out of the profit of the relative year.
The cost of the Goodwill to the company was ₹ 5,00,000. Capital employed at the beginning of the year 2013 was ₹ 19,30,000 including the cost of Goodwill and balance in Profit and Loss Account at the same time was ₹ 60,000.

9. The Balance Sheet of Star Co. Ltd. is as follows :

Balance Sheet of Star Ltd. as at 31st March, 2016

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 30,000 Equity Shares of ₹ 10 each fully paid			3,00,000
(b) Reserves and Surplus — Capital Reserve			20,000
Profit and Loss Account — Opening Balance			11,000
Profit of Current Year			55,000
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors			71,000
(b) Other Short-term Provisions — Provision for Taxation			55,000
TOTAL			5,12,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			1,75,000
Land and Buildings			90,000
Plant and Machinery			30,000
(ii) Intangible Assets — Goodwill at Cost			
(2) Current Assets :			
(a) Inventories at Cost			1,15,000
(b) Trade Receivables			
Book Debts	98,000		
Less: Provision for Bad Debts	3,000		95,000
(c) Cash and Cash Equivalents — Cash at Bank			7,000
TOTAL			5,12,000

You are asked to value the goodwill of the company on the basis of 5 years' purchase of super profits, for which purpose, the following information are supplied :

(i) Rate of income tax is 50%.

(ii) Reasonable return on capital is 12%.

Valuation of Shares

10. The following is the Balance Sheet of XYZ Ltd. as on 31st Marchr, 2016:

Balance Sheets of XYZ Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 50,000 Equity Shares of ₹ 10 each fully paid		5,00,000
(b) Reserves and Surplus — Profit and Loss Account		1,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables : Sundry Creditors		40,000
Bills Payable		10,000
TOTAL		6,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		2,00,000
Land and Builsing		1,50,000
(ii) Intangible Assets — Goodwill		40,000
(b) Non-current investments		60,000
(2) Current Assets :		
(a) Inventories		1,00,000
(b) Trade Receivables — Debtors		80,000
(c) Cash and Cash Equivalents — Cash at Bank		20,000
TOTAL		6,50,000

From the above information, you are asked to ascertain the value of each equity share of the company.

11. The following is the Balance Sheet of D Company Ltd. as on 31st March, 2016 :

Balance Sheet of D Company Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus — General Reserve		45,000
Profit and Loss Account		18,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		12,500
(b) Trade Payables — Creditors		70,000
(c) Short-term Provisions — Proposed Preference Dividend		13,500
TOTAL		6,59,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		2,99,000
(ii) Intangible Assets — Goodwill		55,000
(2) Current Assets :		
(a) Cash and Cash Equivalents — Cash at Bank		75,000
(b) Other Current Assets		2,30,000
TOTAL		6,59,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
35,000 Equity Shares of ₹ 10 each fully paid	3,50,000
1,500, 9% Preference Shares of ₹ 100 each fully paid	1,50,000
	5,00,000

The assets are valued as follows :
Current assets at ₹ 2,35,000; Fixed assets at ₹ 2,80,000; and Goodwill at ₹ 60,000.
Calculate the value of equity shares and preference shares. The preference shares are non-participating.

12. The following is the Balance Sheet of ABC Ltd. as on 31st March, 2016 :

Balance Sheet of ABC Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,50,000
(b) Reserves and Surplus — General Reserve		22,000
Profit and Loss Account		10,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		50,000
(b) Trade Payables — Sundry Creditors		15,000
TOTAL		5,47,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		2,05,000
Furniture		30,000
(ii) Intangible Assets — Goodwill		70,000
(2) Current Assets :		
(a) Inventories		1.40.000
(b) Trade Receivables — Sundry Debtors		80.000
(c) Cash and Cash Equivalents — Cash at Bank		22.000
TOTAL		5,47,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
3,000 Equity Shares of ₹ 100 each fully paid	3,00,000
1,500, 8% Preference Shares of ₹ 100 each fully paid	1,50,000
	4,50,000

The value of assets is assessed as follows :

(1) Furniture is to be depreciated at 10%.

(2) Value of stock-in-trade, land and building and goodwill is estimated at ₹ 1,20,000, ₹ 2,50,000 and ₹ 80,000 respectively.

(3) Debtors are expected to realise 80% of book value.

Find out the value of equity shares.

13. The following is the Balance Sheet of B Company Ltd. as on 31st March, 2016 :

Balance Sheet of B ompany Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 6,000 Equity Shares of ₹ 100 each fully paid		6,00,000
(b) Reserves and Surplus — General Reserve		70,000
Profit and loss Account		20,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 500, 6% Debentures of ₹ 100 each		5,00,000
(4) Current Liabilities :		
(a) Trade Payabes		30,000
(b) Other Liabilities		10,000
TOTAL		12,30,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		4,10,000
Plant and Machinery		3,40,000
Furniture		60,000
(ii) Intangible Assets — Goodwill		70,000
(b) Non-current investments		1,00,000
(2) Current Assets :		
(a) Inventories		1,20,000
(b) Trade Receivables — Sundry Debtors		80,000
(c) Cash and Cash Equivalents — Cash at Bank		50,000
TOTAL		12,30,000

All the assets were independently valued at ₹ 13,80,000.
The company earned net profits for the last five years as follows : ₹ 80,000, ₹ 84,000, ₹ 92,000, ₹ 88,000 and ₹ 96,000.
It was decided to set aside 15% of the profits towards General Reserve. This proportion was considered reasonable in the industry in which the company was engaged and where a fair investment return may be taken at 10%.
Find out the value of equity shares of the company under : (a) Assets Valuation; and (b) Yield Valuation Method.

14. The following is the Balance Sheet of C Company Ltd. as on 31st March, 2016 :

Balance Sheet of C Company Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,50,000
(b) Reserves and Surplus — General Reserve		10,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Bills Payable		32,000
Creditors		28,000
TOTAL		2,20,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Freehold Property		80,000
Plant and Machinery		90,000
(2) Current Assets :		
(a) Other Current Assets		50,000
TOTAL		2,20,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
1,000 Equity Shares of ₹ 100 each fully paid	1,00,000
500, 6% Preference Shares of ₹ 100 each fully paid	50,000
	1,50,000

The net profits for the five years were ₹ 37,000; ₹ 42,000; ₹ 40,000; ₹ 43,000; and ₹ 38,000 before providing for taxation at 50%; general reserve at 15% and also dividend for preference shareholders.
The position of a similar company was as follows :

(a) Its equity shares quoted on the Inventories Exchange were round about par.
(b) Its latest dividend was 10%.
(c) Its 5% preference shares were quoted at par.

The preference shares were cumulative, non-participating with priority as to repayment of capital on winding up. Further, the share capital had remained constant throughout the history of the company and adequate depreciation had been provided for fixed assets.
Calculate the value of shares by the Yield Valuation Method and also find out the value of goodwill of the company from the particulars given above.

15. On December 31, 2015, the Balance Sheet of P Ltd.reveals the following position :

Balance Sheet of P Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 40,000 Equity Shares of ₹ 10 each fully paid		4,00,000
(b) Reserves and Surplus — General Reserve		90,000
Profit and Loss Account		20,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		1,00,000
(4) Current Liabilities :		
(a) Other Current Liabilities		1,30,000
TOTAL		7,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		5,00,000
(ii) Intangible Assets — Goodwill		40,000
(2) Current Assets :		
(a) Other Current Assets		2,00,000
TOTAL		7,40,000

On December 31, 2015, the fixed assets were independently valued at ₹ 3,50,000 and the goodwill at ₹ 50,000. The net profits for the three years were : 2013 — ₹ 51,600; 2014 — ₹ 52,000; 2015 — ₹ 51,650 of which 20% was placed under reserve, this proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 10%. Compute the value of the company's shares by (a) the Net Assets Method; (b) the Yield Value Method; and, (c) the Earning Capacity Method.

16. The following is the Balance Sheet of F Company Ltd. as on December 31, 2015 :

Balance Sheet of F Company Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 3,000 Equity Shares of ₹ 100 each fully paid		3,00,000
(b) Reserves and Surplus — General Reserve		80,000
Profit and Loss Account		27,900
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		50,000
(b) Trade Payables — Creditors		70,000
(c) Other Liabilities		20,000
TOTAL		5,47,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		1,35,000
Land and Building		2,74,000

(2) Current Assets :		
(a) Trade Receivables — Sundry Creditors		48,500
(b) Cash and Cash Equivalents — Cash at Bank		90,000
TOTAL		5,47,500

You are required to ascertain the fair value of the equity shares of the company from the following particulars :

(1) The company has been earning profits at an increasing trend consistently for the past three years as follows : 2013 — ₹ 1,75,000; 2014 — ₹ 2,10,000; and, 2015 — ₹ 2,50,000.
(2) The company sets aside from the profits 40% for Taxation and 15% towards general reserves.
(3) The prospects of the company for the year 2016 are considered to be good.
(4) Companies engaged in similar activities show a profit of 10% on market value of their shares.
(5) Goodwill is considered to be worth three years' purchase of super profits.
(6) The debtors are expected to realise ₹ 46,000.
(7) The present value of land and building is estimated at ₹ 3,00,000.

17. Following is the Balance Sheet of Bharat Lamp Ltd. as at 31st December, 2015 :

Balance Sheet of Bharat Lamp Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,20,000 Equity Shares of ₹ 10 each fully paid		12,00,000
(b) Reserves and Surplus — General Reserve		1,20,000
Profit and Loss Account		2,40,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Trade Creditors		5,40,000
(b) Short-term Provisions — Provision for Tax		3,60,000
(c) Other Current Labilities — Workers Savings Account		1,80,000
TOTAL		26,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		6,60,000
Plant and Machinery		7,80,000
(ii) Intangible Assets — Patents		1,,20,000
(2) Current Assets :		
(a) Inventories		2,40,000
(b) Trade Receivanbles — Trade Debtors		5,40,000
(c) Cash and Cash Equivalents — Cash at Bank		3,00,000
TOTAL		26,40,000

(a) The Land and Building is valued at ₹ 14,40,000 and the Plant and Machinery at ₹ 7,20,000.
(b) Out of the Trade Debtors, Debtors worth ₹ 36,000 are considered bad.
(c) The goodwill of the company is considered worth ₹ 10,80,000. All other assets were taken at their book values.

The profits of the company were as follows : 2013 — ₹ 4,80,000; 2014 — ₹ 5,40,000; and 2015 — ₹ 6,36,000.

You are to ascertain the value of the shares of the company on the "Net Assets Basis" and the "Yield Basis", considering the following points :

(i) The company is in the practice of transferring 25% of the profits to the General Reserve; and
(ii) Similar companies pay dividends @ 10% on the market value of the equity share. Ignore taxation.

18. The following is the Balance Sheet of XYZ Ltd. as on 31st December, 2015 :

Balance Sheet of XYZ Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 15,000 Equity Shares of ₹ 10 each fully paid		1,50,000
(b) Reserves and Surplus — General Reserve		60,000
Capital Reserve		20,000
Profit and Loss Account		60,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		46,850
(b) Short-term Provisions — Proposed Dividend		17,250
Provision for Tax		41,000
(b) Other Current Liabilities — Income Tax Payable		5,750
TOTAL		4,00,850
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Freehold Premises		60,000
Plant		30,000
(2) Current Assets :		
(a) Inventories		1,50,000
(b) Trade Receivables — Debtors		1,01,500
(c) Cash and Cash Equivalents — Cash at Bank		59,350
TOTAL		4,00,850

Net profits (before taxation) for the past three years :
Year ended 31st December :
2013 — ₹ 69,000;
2014 — ₹ 91,500;
2015 — ₹ 98,500.
Freehold premises were valued early in 2015 at ₹ 80,000. Average yield in this type of business is 15% on capital employed.
You are required to find out the fair value of each share on the basis of above mentioned facts, assuming the weights for 2013, 2014 and 2015 were agreed as 1, 2 and 3 respectively.

19. From the following Balance Sheet of XYZ Ltd. as on 31st December, 2015, you are required to ascertain the fair value of the company's shares showing in detail your calculation:

Balance Sheet of XYZ Ltd. as at 31st December, 2015

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 25,000 Equity Shares of ₹ 10 each fully paid			2,50,000
(b) Reserves and Surplus — General Reserve			60,000
Profit and Loss Account			
Balance on 1.1.2015	30,000		
Profit for the year	2,00,000		2,30,000
(2) Share Application Money Pending Allotment :			—

(3) Non-current Liabilities :			—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors			40,000
TOTAL			5,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Building at Cost	40,000		
Less: Depreciation Fund	6,500		33,500
Furniture at Cost			2,000
(b) Non-current investments at Cost	2,00,000		
Less : Depreciation Fund	15,000		1,85,000
(2) Current Assets :			
(a) Inventories at Market Value			2,10,000
(b) Trade Receivables — Sundry Debtors (all good)			1,00,000
(c) Cash and Cash Equivalents — Cash at Bank			49,500
TOTAL			5,80,000

The following information is given :

(a) The company's prospect for 2016 are equally good.

(b) The market value of building is ₹ 1,00,000 and that of furniture is ₹ 6,000.

(c) Profits for the past three years have recorded an increase of ₹ 20,000 per annum.

(d) Companies of similar nature are showing a profit earning capacity of 10% on market value of shares.

(e) Investments earn interest at 5% per annum.

20. The following is the summarised Balance Sheet of Electronics Products Ltd. as on 31st December, 2015 :

Balance Sheet of Electronics Products Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 30,000 Equity Shares of ₹ 10 each		3,00,000
(b) Reserves and Surplus — General Reserve		1,20,000
Capital Reserve		40,000
Profit and Loss Account		1,20,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Creditors		93,700
(b) Short-term Provisions — Proposed Dividend		34,500
Provision for Taxation		82,000
(c) Other Current Liabilities — Income Tax Payable		11,500
TOTAL		8,01,700
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Freehold Property		1,20,000
Plant		50,000
(2) Current Assets :		
(a) Inventories		3,10,000
(b) Trade Receivables — Debtors		2,03,000
(c) Cash and Cash Equivalents — Cash at Bank		1,18,700
TOTAL		8,01,700

Net profit (before taxation) for the last three years were ₹ 1,38,000; ₹ 1,83,000; and ₹ 1,97,000 respectively. Freehold property may be valued at ₹ 1,60,000. Average yield in this type of business is 15% on capital employed.
You are required to find out the intrinsic value and the yield value of each equity share on the basis of above-mentioned facts.

21. The following is the Balance Sheet of X Co. Ltd. as on 31.12.2015 :

Balance Sheet of X Co. Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus — General Reserve		60,000
Profit and Loss Account		18,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 15% Debentures		1,0,000
(4) Current Liabilities :		
(b) Trade Payables — Creditors		80,000
TOTAL		4,58,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Buildings		1,50,000
Plant		1,00,000
(ii) Intangible Assets — Goodwill at Cost		50,000
(b) Non-current investments —		
Investment in 10% Stock (Market Value ₹ 52,000 and Nominal Value ₹ 50,000)		48,I000
(2) Current Assets :		
(a) Inventories		60,000
(b) Trade Receivables — Debtors		40,000
(c) Cash and Cash Equivalents — Cash in Hand		10,000
TOTAL		4,58,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 10 each fully paid	1,00,000
1,000, 12% Preference Shares of ₹ 100 each fully paid	1,00,000
	2,00,000

Ascertain the value of each equity share under fair value method on the basis of information given below :
Assets are revalued as follows : Building — ₹ 3,20,000; Plant — ₹ 1,80,000; Inventories — ₹ 45,000; and Debtors — ₹ 36,000.
Average profit of the company is ₹ 1,20,000 and $12^1/_2$% of profit is transferred to General Reserve, rate of taxation being 50%. Normal dividend expected on equity shares is 8% where fair return on capital employed is 10%. Goodwill may be valued at 3 years purchase of super profits.

22. The following figures relate to a company which has ₹ 10,00,000 in Equity Shares and ₹ 3,00,000 in 9%, Preference shares, all of ₹ 100 each :

	Average Net worth (excluding investment)	Adjusted Taxed Profit
2013	₹ 18,60,000	₹ 1,90,000
2014	₹ 21,50,000	₹ 2,10,000
2015	₹ 21,90,000	₹ 2,50,000

The company has investments worth ₹ 2,80,000 (at market value) on the valuation date, the yield in respect of which has been excluded in arriving at the adjusted tax profit figures. It is customary for similar types of companies to set aside 25% of the taxed profit for rehabilitation and replacement purposes. On the valuation date, the net worth (excluding investments) amount to ₹ 22,50,000. The normal rate of return expected is 9%. The company has paid dividends consistently within a range of 8% to 10% on equity shares over the previous seven years and it expects to maintain the same.

You are required to ascertain the value of each equity share on the basis of productivity, applying suitable weighted averaging.

Guide to Answers

Multiple Choice

1. A; 2. B; 3. B; 4. B; 5. B.

Practical Questions

1. (a) ₹ 80,000; (b) ₹ 60,480 (₹ 16,000 × 3.78); (c) ₹ 1,60,000.
2. ₹ 92,857
3. ₹ 1,00,000
4. Hammer Ltd. — ₹ 24,000; Grace Ltd. — ₹ 32,000.
5. ₹ 26,460
6. ₹ 60,000
7. ₹ 36,600
8. ₹ 19,00,000.
9. (i) Capital employed — ₹ 3,56,000; (ii) Super Profit — ₹ 12,280; (iii) Goodwill — ₹ 61,400.
Tutorial Note : Profit for the current year has been calcukated after providing for income tax ₹ 55,000. Therefore, no adjustment is necesary for tax.
10. Intrinsic value of each equity shares — ₹ 12.
11. Intrinsic value of each equity share — ₹ 11.54; Intrinsic value of each preference share — ₹ 109 (cum-interest)
12 Intrinsic value of each equity share — ₹ 116.
13. Value of each share under assets valuation method — ₹ 140.
Value of each share under yield valuation method — ₹ 124.66
14. Value of each share under yield valuation method — ₹ 110
Value of goodwill — ₹ 10,000.
15. Value of each share under : (a) Net assets method — ₹ 9.25; (b) Yield value method — ₹ 10.35; and (c) Earnings capacity method — ₹ 12.07.
16. Average capital employed — ₹ 2,93,500; Super profits — ₹ 1,05,150; Goodwill — ₹ 3,15,450. Value of each share : under assets backing method — ₹ 248.82; yield method — ₹ 336.00.
17. Capital employed — ₹ 33,24,000; Intrinsic value of a share — ₹ 27.70; Yield value of a share — ₹ 34.50.
18. Capital employed — ₹ 3,51,000. Super Profit — ₹ 7,025. Intrinsic Value of a share : (ex-dividend) ₹ 23.40; (cum-dividend) ₹ 24.55; Earning capacity : ₹ 18.25.
19. Capital employed — ₹ 2,78,000; Super profit — ₹ 57,200; Value of a share : Intrinsic value — ₹ 27.28; Yield value — ₹ 32.40; Fair value — ₹ 29.84.
20. Capital employed — ₹ 7,02,000; Super profit (–) ₹ 18,967; Value of a share : Intrinsic value — ₹ 23.40; Yield value — ₹ 17.26.
21. Capital employed : ₹ 5,61,000; Super profit : ₹ 8,900; Value of a share : Intrinsic value — ₹ 43.97; Yield value — ₹ 56.63.
22. Value of an equity share — ₹ 198.25.

10

Amalgamation

Introduction

Amalgamation is the process of mixing two or more entities into one entity. The assets and liabilities are brought under common control in a single legal entity. The shareholders of the transferor company are allotted shares in the transferee company. The shareholders have a continuing interest in the risks and benefits of the transferee company. The substance of amalgamation is that the businesses of the transferor and the transferee companies continue to be run as before, though under a single corporate name.

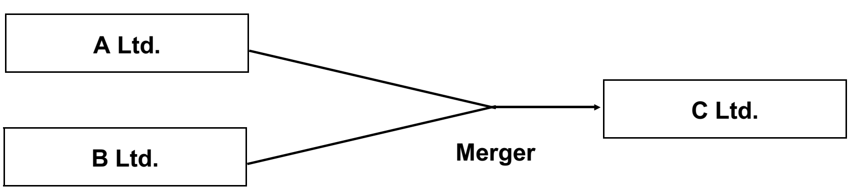
***It should be noted that amalgamation includes absorption and external reconstruction*.**

Forms of Amalgamation

Companies have always tried to grow through the development of new products and expansion of existing products in the new potential markets. In many cases, however, the desired growth can be achieved through amalgamation (merger and acquisition). Amalgamation may take one of the following forms, as illustrated below:

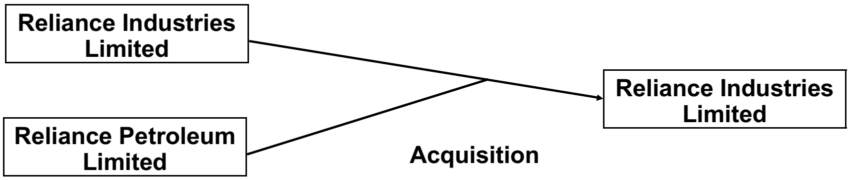
(a) Merger

In this case both the combining companies are dissolved and assets and liabilities of both companies are transferred to a newly created company. The operations of the previously separate companies are carried on as a single legal entity.



(b) Acquisition

In this case only one of the combining companies survives and the other loses its separate identity. The assets and liabilities of the acquired company are transferred to the acquiring company. The acquired company is dissolved. The acquiring company will continue as usual.



There are generally three common ways in which companies can amalgamate together to gain advantage in their market. They are as under :

Horizontal It is an amalgamation that takes place between two companies in the same line of business. For example, when a tea company amalgamates with another tea company. The main purpose of horizontal amalgamation is the acquisition of a competitor, by either companies, in the same line of business, which increases the market share and reduce competition in one stroke.

Vertical It is an amalgamation that takes place when a company amalgamates with a supplier or a customer. Both strengthen the amalgamated company's competitive position and may enable it to diversify.

Conglomerate Conglomerate is a diversified group of companies. In a conglomerate amalgamation, the amalgamating companies are in totally unrelated lines of business. The main purpose of conglomeration is diversification of risks.

Real Life Focus

Some of the important acquisitions of 2015 are given below :

1. **Reliance Infrastructure acquires India's largest ship building and heavy industries company Pipavav Defence and Offshore Engineering Company Limited.**
2. **Ola Cabs acquires TaxiforSure.**
3. **Star India Pvt. Ltd. owned by 21st Century Fox acquires Screen entertainment weekly from Indian Express Group.**
4. **Snapdeal acquires Exclusively.com.**
5. **BookMyShow acquires Bangalore-based Eventifier.**
6. **Foodpanda acquires food ordering portal Just Eat India.**
7. **Zomato buys Turkish rival Mekanist.**
8. **Emami Ltd. acquires Australian personal care firm Fravin pvt. Ltd.**
9. **Godrej Consumer Products Ltd. acquires South Africa's Frica Hair (Pty) Ltd.**
10. **Apollo Hospital acquires Nova Speciality.**

Motive for Amalgamation

Amalgamation is based on the concept of ***synergy***. Synergy is a relationship in "2 + 2 = 5 effect", where the whole is greater than the sum of the parts. Synergetic benefits can arise, where two companies can achieve more in combination than in their individual parts. To put it in another way, the value of the amalgamated company is expected to be greater than the sum of the independent values of the amalgamating companies, because of efficiency and cost savings through eliminating duplicate facilities. Taking the above example, the concept of synergy can be explained symbolically as follows :

$$V(AB) > V(A) + V(B)$$

where, V(AB) is the value of the amalgamated company AB,

V(A) is the independent value of the amalgamating company A before amalgamation, and

V(B) is the independent value of the amalgamating company B before amalgamation.

Any reasonable motive for amalgamation is to provide economic gains — in the form of increased economies or tax savings. The main motives for amalgamations are :

***(1) Economies of Scale* —** The amalgamated company can have operating cost advantage, in effect, lower average cost of production.

***(2) Financial Economies* —** Financial economies can be in the form of tax-advantage, higher debt capacity and lower rates of borrowing, less flotation of shares and debentures, etc.

***(3) Growth* —** Internal growth is time consuming. It can also prevent a competitor from establishing a similar position in that industry. In a saturated market, amalgamation makes more sense than creation of additional production capacity through internal expansion.

***(4) Diversification* —** In an amalgamation, risk of the company can be lowered by diversifying into two or more industries. Diversification is a situation in which a company takes on new lines of business, to reduce the degree of risk.

***(5) Managerial Effectiveness* —** Effectiveness is the degree of attainment of a predetermined goal. Management effectiveness can be availed of through superior management talent or a research capability.

In this connection the extract from the Scheme of Amalgamation of Reliance Petroleum Limited (RPL) with Reliance Industries Limited (RIL) is given below:

The Board of Directors of RPL and RIL considered a number of factors in deciding to approve the amalgamation. The material factors they considered are those set out below :

A. Size, Scale, Integration and Financial Strength

The amalgamation will create India's largest private sector company, in terms of assets, net worth, sales and profits, and one of the world's largest and most integrated energy and petrochemical companies. The amalgamated entity will have the ability to leverage on its large asset base, diverse range of products and services, and vast pool of intellectual capital, to enhance shareholder value. The amalgamation will result in increased financial strength and flexibility, and enhance the ability of the amalgamated entity to undertake large projects, thereby contributing to enhancement of future business potential of the companies. The Board of Directors of RIL and RPL believe that the integrated facilities of the amalgamated entity, leading market shares, and proprietary skill sets and capabilities, will provide a unique competitive advantage for future growth opportunities.

The Board of Directors of RIL and RPL believe that in the context of the ongoing reforms in the hydrocarbon sector in the country, the combination of assets and resources, together with the amalgamated entity's financial strength and flexibility, will enable the pursuit of opportunities including setting up of marketing infrastructure for petroleum products in a short period of substantial scale, which are available only to the most competitive international energy companies.

B. Global competitiveness

The integration of the manufacturing and other facilities of RPL will contribute to enhanced global competitiveness for the amalgamated entity, thereby increasing its ability to compete with its peer group in domestic and international markets.

C. Market leadership

The amalgamation will contribute strengthening Reliance's existing market leadership in all its major products. The amalgamated entity will be a major player in the energy and petrochemical sector, bringing together Reliance's leading positions in different product categories.

D. Industry consolidation

The Indian energy and petrochemicals industry is undergoing a consolidation phase, particularly in view of the Government's approach towards hydrocarbon sector reforms and disinvestment of public sector enterprises. The amalgamated entity will have greater potential to effectively participate in this process of consolidation, through its enhanced financial strength and the increased ability to meet competition.

E. Strategic fit and site integration

The Board of Directors of RIL and RPL considered the complementary nature of the businesses of RIL and RPL, in terms of their commercial strengths, geographic profiles and site integration. The major part of the total asset base of the amalgamated entity will be located in the state of Gujarat, at Hazira and Jamnagar. This will enable the amalgamated entity to conduct operations in the most cost effective and efficient manner. The amalgamation will also enable optimal utilisation of various infrastructure and manufacturing assets, including utilities and other site facilities.

F. Synergies

The combination of upstream and downstream operations of RIL and RPL will create a unique level of integration for the amalgamated entity, spanning the entire value chain in the energy business. This will enable the amalgamated entity to achieve substantial savings in costs, significantly enhancing its earnings potential. The estimated cost savings are expected to flow from more focused operational efforts, rationalisation, standardisation and simplication of business processes, productivity improvements, improved procurement, and the elimination of duplication.

G. Enhanced organisational capabilities

The amalgamated entity will benefit from improved organisational capability, arising from the combination of people from RIL and RPL who have the diverse skills, talent and vast experience to compete successfully in an increasingly competitive industry. The amalgamated entity will also benefit from the proven leadership and management ability of both companies in all facets of the energy and petrochemicals business, and a consistent track record of success in executing key strategies.

H. Complementary management strategies

RIL and RPL share common fundamental management philosophies. Both companies pursue sustainable growth within a conservative financial framework. In addition, it is expected that the amalgamated entity will adopt a dividend policy in line with the existing policies of RPL and RIL. The two companies also share common corporate values. These value include protection of the environment, active support for the communities where they operate, promoting diversification and opportunity in the workforce and among business partners, and providing sustained returns to shareholders. The companies have a long and highly rewarding experience of working together, and the Board of Directors of RIL and RPL believe this will contribute to a smooth integration of the companies.

1. Other factors

(a) The amalgamation is expected to be beneficial to the shareholders of both, RIL and RPL. The amalgamation will enhance value for shareholders of both companies through the amalgamated entity's access to greater market resources. The amalgamation will enhance value for shareholders of RPL through the resulting large asset base and scale of operations, particularly RIL's upstream operations in oil and gas which will reduce exposure to imports of feedstock, access to RIL's strong corporate relationships built up over three decades, entry into new sectors, and access to the vast talent pool of RIL and its subsidiaries. RIL shareholders will benefit from the business of refining and marketing of petroleum products presently carried out by RPL, and the access to RPL's strong cash flows.

(b) Investments in oil and gas exploration and production, entry into retail marketing of transportation fuels in accordance with approvals that may be granted by the government, and participation in the disinvestment programme for public sector oil companies, will require additional resources on a substantial scale. The amalgamated entity will be better positioned to meet these increased resource requirements.

(c) The proposed deregulation of the marketing of 'controlled' petroleum products may entail setting up marketing infrastructure across various parts of the country to meet the high demand of the Indian consumer base. The amalgamated entity will be better positioned to meet these increased resource requirements.

(d) An integrated and synergistic approach will be essential to function more effectively in an increasingly competitive environment. Therefore, the Board of Directors of RPL and RIL believed that amalgamation of the two companies was desirable.

(e) The process of integration of operations of RPL with RIL is expected to be smooth in view of the existing strong relationships between the two companies.

Requirement of the Companies Act, 2013 in Respect of Mergers / Amalgamation

The Companies Act, 2013 has simplified the process of mergers, amalgamation and acquisitions. It will help domestic and cross-border mergers and acquisitions. Some of the key requirements relating to mergers/ amalgamation are given below :

1. The application to be made to the Tribunal for approval of the Scheme of the amalgamation or merger of the companies.
2. The Tribunal will not approve a Scheme of amalgamation or merger unless the accounting treatment prescribed in the Scheme is in confirmity with the notified Accounting Standard. It is important to note that a certification from the company's auditor in this respect is also to be submitted to the Tribunal and it is applicable to all types of companies.
3. The Companies Act, 2013 restricts a transferee company from holding the shares in its own name or in the name of a trust. Any inter-company investments between companies must be cancelled.
4. The Tribunal after satisfying itself that the procedure has been complied with, may, by order, sanction the scheme of amalgamation / merger or by a subsequent order, make provision for the following matters, namely—
   (a) the transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of the transferor company from a date to be determined by the parties unless the Tribunal, for reasons to be recorded by it in writing, decides otherwise;
   (b) the allotment or appropriation by the transferee company of any shares, debentures, policies or other like instruments in the company which, under the compromise or arrangement, are to be allotted or appropriated by that company to or for any person.
5. In case of merger / amalgamation of companies, the following documents should also be circulated :
   (a) the draft of the proposed terms of the scheme drawn up and adopted by the directors of the merging company;
   (b) confirmation that a copy of the draft scheme has been filed with the Registrar;
   (c) a report adopted by the directors of the merging companies, explaining effect of compromise on each class of shareholders, key managerial personnel, promotors and non-promoter shareholders laying out in particular the share exchange ratio, specifying any special valuation difficulties;
   (d) the report of the expert with regard to valuation, if any;
   (e) a supplementary accounting statement if the last annual accounts of any of the merging company relate to a financial year ending more than six months before the first meeting of the company summoned for the purposes of approving the scheme.

Merger of Listed Companies with Unlisted Companies

Where the transferor company is a listed company and the transferee company is an unlisted company,—

(a) the transferee company shall remain an unlisted company until it becomes a listed company;

(b) if shareholders of the transferor company decide to opt out of the transferee company, provision shall be made for payment of the value of shares held by them and other benefits in accordance with a pre-determined price formula or after a valuation is made, and the arrangements under this provision may be made by the Tribunal:
Provided that the amount of payment or valuation under this clause for any share shall not be less than what has been specified by the Securities and Exchange Board under any regulations framed by it.

Fast-track Merger or Amalgamation

The Companies Act, 2013 has introduced the new concept of fast-track merger or amalgamation. Under this scheme, merger or amalgamation may be entered into between two or more *small companies* or between a holding company and its *wholly-owned subsidiary company* or such other class or classes of companies as may be prescribed, subject to the following, namely:—

(a) a notice of the proposed scheme inviting objections or suggestions, if any, from the Registrar and Official Liquidators where registered office of the respective companies are situated or persons affected by the scheme within ***thirty*** days is issued by the transferor company or companies and the transferee company;

(b) the objections and suggestions received are considered by the companies in their respective general meetings and the scheme is approved by the respective members or class of members at a general meeting holding at least ***ninety per cent*** of the total number of shares;

(c) each of the companies involved in the merger files a ***declaration of solvency***, in the prescribed form, with the Registrar of the place where the registered office of the company is situated; and

(d) the scheme is approved by majority representing ***nine-tenths in value of the creditors*** or class of creditors of respective companies indicated in a meeting convened by the company by giving a notice of twenty-one days along with the scheme to its creditors for the purpose or otherwise approved in writing.

Procedures

The following procedures are followed in an amalgamation :

1. The board of directors of the constituent companies work out the terms of the amalgamation.
2. A scheme of amalgamation is prepared and submitted to the respective Tribunal for approval.
3. Shareholders of the constituent companies approve the terms of the amalgamation in accordance with the provisions of the Companies Act and the Memorandum of Association.
4. Approval of the SEBI is obtained.
5. A new company is formed (where necessary) to issue its own shares to the shareholders of the transferor company.
6. The transferor company is ***liquidated*** and all assets and liabilities are taken over by the transferee company.

Accounting for Amalgamation

The council of the Institute of Chartered Accountants of India has issued Accounting Standard — 14, ‘Accounting for Amalgamation, which states the procedures for accounting for amalgamations. This standard is mandatory in nature and effective from accounting periods commencing on or after 1.4.1995.

It is to be noted that the Central Government in consultation with National Advisory Committee on Accounting Standard (NACAS) has amended some of the provisions of AS–14.

All the following matters are as per the Companies (Accounting Standards) Amendment Rules, 2016 (effect from 30th March, 2016).

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

(a) ***Amalgamation*** means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies and includes ‘***merger***’.

(b) ***Transferor company*** means the company which is amalgamated into another company.

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

(d) ***Reserve*** means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

(e) ***Fair value*** is the amount for which an asset could be exchanged between a knowledgeable willing buyer and a knowledgeable willing seller in an arm’s length transaction.

Types of Amalgamation

Accounting problems of amalgamation are dealt with in AS—14 according to the type of amalgamation. The standard recognises two types of amalgamation :

(i) Amalgamation in the nature of merger; and **(ii) Amalgamation in the nature of purchase**.

Amalgamation in the Nature of Merger

An amalgamation will be treated as 'Amalgamation in the Nature of Merger' if ***all*** the following ***five*** conditions are satisfied :

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

The unique attributes of this type of amalgamation are the carryforward of assets and liabilities at book values and the carryforward of retained earnings. In addition, equity shareholders of the transferor companies continue to have a proportionate share in the transferee company.

Amalgamation in the Nature of Purchase

An amalgamation will be treated as 'Amalgamation in the Nature of Purchase' if only one or more of the five conditions specified above (for amalgamation in the nature of merger) is not satisfied. These are amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued.

Calculation of Purchase Consideration

Calculation of purchase consideration is one of the major task in the process of amalgamation of companies. The purchase consideration is determined as per the agreement between the companies. While calculating purchase consideration, the provision of AS—14, Para 3(g) must be taken into consideration. It defines the expression 'Purchase Consideration' as "the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company."

Points to Remember

(1) Only payment to shareholders are to be taken into consideration.

(2) Consideration for debentureholders will not be included in the purchase consideration.

(3) Liquidation expenses or payment for cost of absorption are not included in the purchase consideration.

Illustration 1

The Balance Sheet of X Co. Ltd. and Y Co. Ltd. as at 31st March, 2016 are as follows

Balance Sheets of X Co. Ltd. and Y Co. Ltd. as at 31st March, 2016

Particulars	Note No.	X Co. Ltd. (₹)	Y Co. Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	3,00,000	1,50,000
(b) Reserves and Surplus :			
General Reserve		50,000	30,000
Profit and Loss Account		50,000	20,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sundry Creditors		40,000	15,000
TOTAL		4,40,000	2,15,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		1,40,000	75,000
Plant and Machinery		1,10,000	50,000
(ii) Intangible Assets — Goodwill		30,000	20,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		60,000	35,000
(c) Trade Receivables		60,000	20,000
(d) Cash and Cash Equivalents		40,000	15,000
TOTAL		4,40,000	2,15,000

Notes to Accounts :

(1) Share Capital

Particulars	X Co. Ltd. ₹	Y Co. Ltd. ₹
Authorised Capital :		
... Equity Shares of ₹ ... each	?	?
... Preference Shares of ₹ ... each	?	?
	?	?
Issued and Subscribed Capital :		
10,000 Equity Shares of ₹ 30 each fully paid	3,00,000	—
10,000 Equity Shares of ₹ 15 each fully paid	—	1,50,000
	3,00,000	1,50,000

The two companies decided to amalgamate into a new company Z Co. Ltd. which will take over the assets and liabilities of these companies at the following terms :

X Co. Ltd. : Holders of each share of ₹ 30 each in the company, would receive 6 equity shares of ₹ 5 each fully paid and ₹ 5 in cash.

Y Co. Ltd. : Holders of each share of ₹ 15 each in the company, would receive one 12% preference share of ₹ 10 each fully paid-up and ₹ 10 in cash.

The liquidation expenses of the two companies ₹ 2,000 and ₹ 1,000 respectively were met by the new company.

You are required to calculate purchase consideration of each company separately.

Solution **Calculation of Purchase Consideration**

X Co. Ltd.	₹	Y Co. Ltd.	₹
(i) Holder of each Equity Share of ₹ 30 each will get 6 Equity Shares of ₹ 5 each in Z Co. Ltd. i.e., ₹ 3,00,000 / 30 × 6 × ₹ 5	3,00,000	(i) Holder of each Equity Share of ₹ 15 each will get one 12% Preference Share of ₹ 10 each fully paid i.e., 1,50,000 / 15 × ₹ 10	1,00,000
(ii) Holder of each Equity Share of ₹ 30 each will get ₹ 5 in cash i.e., ₹ 3,00,000 / 30 × ₹ 5	50,000	(ii) Holder of each Equity Share of ₹ 15 each will get cash of ₹ 10 each i.e., ₹ 1,50,000 / 15 × ₹ 10	1,00,000
Total	3,50,000	**Total**	2,00,000

Note : Liquidation expenses are not included while calculating Purchase Consideration.

Illustration 2

The Trial Balances of Star Limited and Moon Ltd. as on 31st March, 2016 is as under :

	Star Ltd.		Moon Ltd.	
Particulars	Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹
Equity Shares of ₹ 10		2,10,000		1,50,000
9% Redeemable Preference Shares of ₹ 100 each		90,000		
Securities Premium		10,500		
Capital Redemption Reserve		60,000		
General Reserve		49,500		75,000
8% Debentures		60,000		90,000
Goodwill	15,000			
Land	—		30,000	
Building	—		75,000	
Plant	3,00,000		1,35,000	
Fixtures	5,000		15,000	
Vehicles	10,000		15,000	
Inventories	1,20,000		75,000	
Debtors	80,000		50,000	
Advances	50,000		35,000	
Cash & Bank	20,000		20,000	
Creditors		1,20,000		1,35,000
	6,00,000	6,00,000	4,50,000	4,50,000

On 1st April, 2016 Sun Ltd. was formed by amalgamating Star Ltd. and Moon Ltd. on the following terms :

1. Sun Ltd. to issue 60 — 10% Debentures of ₹ 1,000 each to Debentureholders of Star Ltd.
2. The Debentureholders of Moon Ltd. insisted that they should be allotted equity shares in Sun Ltd. Accordingly, they were allotted 9,000 equity shares of ₹ 10 each.
3. Preference shareholders of Star Ltd. insisted for allotment of 900 — 11% Redeemable preference shares of ₹ 100 each.
4. The Equity shareholders of Star Ltd. are to be allotted 10 equity shares at par for 7 equity shares held by them. The shares of Sun Ltd. are of ₹ 10 each.
5. The equity shareholders of Moon Ltd will get :
   (a) 6 equity shares of Sun Ltd at par for 5 equity shares held by them;
   (b) A cash payment of ₹ 2 per share of Moon Ltd.

You are required to show Purchase Consideration payable to Star Ltd and Moon Ltd. — as per AS—14.

Solution **Calculation of Purchase Consideration of Star Ltd.**

Particulars	₹
(i) 900, 11% Preference Shares of ₹ 100 each	90,000
(ii) For 7 Equity Shares of Star Ltd., 10 Equity Shares of ₹ 10 each will be allotted, i.e., $\left[\frac{2,10,000}{10} \times \frac{10}{7} \times 10\right]$	3,00,000
Total	3,90,000

Calculation of Purchase Consideration of Moon Ltd.

Particulars	₹
(i) For 5 Equity Shares of Moon Ltd., 6 Equity Shares of ₹ 10 each will be allotted, i.e., $\left[\frac{1,50,000}{10} \times \frac{6}{5} \times 10\right]$	1,80,000
(ii) Cash payment of ₹ 2 per share, i.e., (15,000 x ₹ 2)	30,000
Total	2,10,000

Tutorial Note : It should be noted that consideration for debentureholders will not be included in the Purchase Consideration. These debentures will be taken over by Sun Ltd and then these are to be discharged.

Illustration 3

Rajnigandha Ltd is absorbed by Vasundhara Ltd, the consideration being the takeover of liabilities; the payment of cost of absorption not exceeding ₹ 20,000 (actual cost ₹ 17,000); the payment of the debentures of ₹ 1,00,000 at a premium of 10% in 9% debentures issued at par; and the payment of ₹ 16 per share in cash and allotment of one 14% preference share of ₹ 10 each and six equity shares of ₹ 10 each fully paid for every four shares in Rajnigandha Ltd. The number of shares of the vendor company are 2,00,000 of ₹ 10 each fully paid.

Calculate purchase consideration as per Accounting Standard—14.

Solution **Calculation of Purchase Consideration**

Particulars	₹
Equity Shareholders :	
Cash — ₹ 16 x 2,00,000	32,00,000
14% Preference Shares — 2,00,000 / 4 x ₹ 10	5,00,000
Equity Shares — 2,00,000 / 4 x 6 / ₹ 10	30,00,000
Total	67,00,000

Note : Payment of cost of absorption and payment to debentureholders are not included while calculating purchase consideration.

Methods of Accounting for Amalgamation

There are two main methods of accounting for amalgamations :

(a) The Pooling of Interests Method; and

(b) The Purchase Method.

It should be noted that the Accounting Standard deals with the accounting procedures only in the books of the transferee company. So far as the books of the transferor company are concerned, the normal procedures are to be followed for closing the books of account through Realisation Account.

Pooling of Interests Method

Pooling method of accounting is applicable for **Amalgamation in the Nature of Merger** (i.e., when all five conditions stated above are satisfied).

Characteristics of Pooling of Interests Method

1. Pooling of interests accounting treats an amalgamation as a '***non-event***', in that the combining companies are viewed as if they always had been together.
2. The unique attributes of pooling of interests accounting are the carryforward of assets and liabilities at book values and the carryforward of retained earnings.
3. Under pooling of interests accounting, ***no goodwill*** is recorded as arising from the amalgamation.
4. All costs associated with the amalgamation or with issuing the shares used in the amalgamation are expended as incurred; none of the costs of bringing about the amalgamation are ***capitalised***.
5. Under pooling of interests accounting, the carryforward of retained earnings of the acquired company may give management more flexibility with respect to dividends subsequent to the amalgamation.

While making accounting entries under this method, the following matters should be taken into consideration :

1. All assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the adjustment required for 'Changes in Accounting Policies and Prior Period and Extraordinary Items').
2. The identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation.
3. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in the financial satements of the tranferee company.
4. No goodwill account should be accounted for as a result of amalgamation in the books of the transferee company.
5. The balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

Accounting Entries in the Books of the Transferee Company

1. For amalgamation of the business

Business Purchase Account	Dr.	[with the amount of purchase consideration]
To Liquidator of Transferor Company Account		

(Being the amount payable to the liquidator of . . . Ltd under the scheme of amalgamation)

2. For assets, liabilities and resources taken over

Sundry Assets Accounts	Dr.	[Individually, at book value]
To Sundry Liabilities Account		[Individually, at book value]
To Reserves Account		[See Note below]
To Profit and Loss Account		
To Business Purchase Account		[With purchase consideration]

(Being different assets and liabilities are taken over under the scheme of amalgamation)

[**Note**: After adjustment of the difference between the amount recorded as share capital issued and the amount of share capital of the transferor company.]

3. For Payment of Purchase Consideration

Liquidator of Transferor Company Account	Dr.	
To Share Capital Account		[Issued]
To Securities Premium Account		[Premium]
To Cash Account		[For fractional shares and for dissenting shareholders]
To Non-Cash Consideration Account		[Fair value for dissenting shareholders in the form of debentures, etc.]

(Being the discharge of purchase consideration)

Accounting Entries in the Books of the Transferor Company

To close the books of account of the transferor company, the following steps are followed :

Step 1 : Prepare the Balance Sheet of the company on the date of liquidation.

Step 2 : Open a Realisation Account and transfer all assets and liabilities (excluding fictitious assets) to this account.

Step 3 : Calculate purchase consideration on the basis of terms and conditions agreed upon.

Step 4 : Credit Realisation Account by purchase consideration.

Step 5 : Calculate profit or loss on realisation.

Step 6 : Transfer share capital, reserve and surplus to Sundry Shareholders Account.

Step 7 : Transfer profit/loss on realisation to Sundry Shareholders Account.

Step 8 : Receiving of purchase consideration in the form of shares/debentures in the transferee company.

Step 9 : Payment to preference shareholders.

Step 10 : Distribution of shares/debentures of transferee company among existing shareholders.

Journal

1. For transferring different assets to Realisation Account

Realisation Account Dr.
To Sundry Assets Account [Individually, at book value]

Points to remember

(a) ***For this purpose agreed valuations are absolutely immaterial.***

(b) ***Goodwill, Patents and Trademark etc., are also transferred to Realisation Account.***

2. For transferring different liabilities to Realisation Account

Liabilities Account Dr. [Individually, at book value]
To Realisation Account

Points to remember

(a) ***Items in the nature of 'Provisions' are to be transferred to Realisation Account only e.g., Employees Provident Fund; Provision for Taxation; Pension Fund; Provision for Bad Debts; Provision for Depreciation, etc.***

(b) ***Items in the nature of 'Reserves' are not to be transferred to Realisation Account. These are transferred to Sundry Shareholders Account. Examples are : Dividend Equalisation Fund;General Reserve; Capital Reserve; Revaluation Reserve; Capital Redemption Reserve; Profit and Loss Account Credit Balance; Workmen Compensation Fund, etc..***

3. For transferring Equity Share Capital, Reserve and Surplus, etc.

Equity Share Capital Account Dr.
General Reserve Account Dr.
Profit and Loss Account Dr.
To Sundry Shareholders Account

Note : Profit and Loss Account debit balance is transferred to Sundry Shareholders Account by debiting Sundry Shareholders Account and crediting Profit and Loss Account.

4. Like Equity Share Capital, Preference Share Capital is closed by transferring to Preference Shareholders Account. The entry for this will be :

Preference Share Capital Account Dr.
To Preference Shareholders Account

Note : If the preference shareholders are paid more or less than the amount due to them as per Balance Sheet, the difference is transferred to Realisation Account.

5. For purchase consideration due from transferee company

Transferee Company Account Dr. [Purchase consideration]
To Realisation Account

6. On receiving purchase consideration from the transferee company

Equity Shares in Transferee Company Account Dr.
Preference Shares in Transferee Company Account Dr.
Debentures in Transferee Company Account Dr.
To Transferee Company Account

7. Entries for liquidation expenses are passed as follows:

(i) If the liquidation expenses are borne by the transferor company

Realisation Account Dr.
To Bank Account

(ii) If the liquidation expenses are borne by the transferee company [No Entry]

8. For payment to preference shareholders

Preference Shareholders Account Dr.
To Preference Shares in Transferee Company Account
To Bank Account (If any)

9. For loss on realisation

Sundry Shareholders Account Dr.
To Realisation Account

10. For profit on realisation

Realisation Account Dr.
To Sundry Shareholders Account

11. For final payment to Equity Shareholders

Sundry Shareholders Account Dr.
To Equity Shares in Transferee Company Account
To Bank Account (If any)

Note : After payment to equity shareholders, all accounts in the books of the transferor company will be closed.

Illustration 4

The following are the Balance Sheets as on 31st March, 2016 of X Ltd. and Y Ltd.

Balance Sheets of X Ltd. and Y Ltd. as at 31st March, 2016

Particulars	Note No.	X Ltd. (₹)	Y Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		1,00,000	60,000
(b) Reserves and Surplus — General Reserve		34,000	—
Dividend Equalisation Fund		4,000	—
Profit and Loss Account		2,000	—

(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 6% Debentures of ₹ 100 each		20,000	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Trade Creditors		10,000	8,000
(c) Other Current Liabilities — Employees P.F.		3,000	—
TOTAL		1,73,000	68,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — : Land and Building		30,000	—
Plant and Machinery		1,10,000	50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		16,000	8,000
(c) Trade Receivables — Sundry Debtors		14,000	9,000
(d) Cash and Cash Equivalents — Cash		3,000	1,000
TOTAL		1,73,000	68,000

In April, 2016, the two companies agree to amalgamate and form a new company called Z Ltd. which takes over the assets and liabilities of both the companies. The authorised Capital of Z Ltd. is ₹ 10,00,000, consisting of 1,00,000 Equity Shares of ₹ 10 each.

The purchase consideration is agreed at ₹ 1,20,000 and ₹ 60,000 for X Ltd and Y Ltd respectively. The entire purchase consideration is to be paid by Z Ltd. in its fully paid shares. In return for debentures in X Ltd. debentures of the same amount and denomination are to be issued by Z Ltd.

Give Journal Entries to close the books of X Ltd. and Y Ltd. and show the Opening entries in the books of Z Ltd. Also prepare the opening Balance Sheet of Z Ltd.

Solution

In the books of X Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Realisation A/c	Dr.		1,73,000	
	To Land and Buildings A/c				30,000
	To Plant and Machinery A/c				1,10,000
	To Inventories A/c				16,000
	To Sundry Debtors A/c				14,000
	To Cash A/c				3,000
	(Being the transfer of different assets to Realisation Account as per the Sch. of amalgamation)				
	6% Debentures A/c	Dr.		20,000	
	Employees' P.F. A/c	Dr.		3,000	
	Trade Creditors A/c	Dr.		10,000	
	To Realisation A/c				33,000
	(Being the transfer of different liabilities to Realisation Account)				
	Equity Share Capital A/c	Dr.		1,00,000	
	General Reserve A/c	Dr.		34,000	
	Dividend Equalisation Fund A/c	Dr.		4,000	
	Profit and Loss A/c	Dr.		2,000	
	To Sundry Equity Shareholders A/c				1,40,000
	(Being the transfer of Share Capital, Reserve and Surplus to Shareholders Account)				
	Z. Ltd. A/c	Dr.		1,20,000	
	To Realisation A/c				1,20,000
	(Being the purchase consideration due from Z Ltd.)				
	Sundry Equity Shareholders A/c	Dr.		20,000	
	To Realisation A/c (Note 1)				20,000
	(Being the loss on realisation transferred to Sundry Equity Shareholders Account)				

	Shares in Z Ltd. A/c Dr. To Z Ltd. A/c (Being purchase consideration received from Z Ltd.)		1,20,000	1,20,000
	Sundry Equity Shareholders A/c Dr. To Shares in Z. Ltd. A/c (Being the distribution of Shares in Z. Ltd. among the existing Shareholders)		1,20,000	1,20,000

In the books of Y Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Realisation A/c Dr. To Plant and Machinery A/c To Inventories A/c To Sundry Debtors A/c To Cash A/c (Being the transfer of different assets to Realisation Account as per the Sch. of amalgamation)		68,000	 50,000 8,000 9,000 1,000
	Trade Creditors A/c Dr. To Realisation A/c (Being the transfer of Trade Creditors to Realisation Account as per the Sch. of amalgamation)		8,000	8,000
	Equity Share Capital A/c Dr. To Sundry Equity Shareholders A/c (Being the transfer of Share Capital to Shareholders Account)		60,000	60,000
	Z. Ltd. A/c Dr. To Realisation A/c (Being the purchase consideration due from Z. Ltd.)		60,000	60,000
	Shares in Z. Ltd. A/c Dr. To Z. Ltd. A/c (Being the purchase consideration received)		60,000	60,000
	Sundry Equity Shareholders A/c Dr. To Shares in Z. Ltd. A/c (Being the distribution of Shares in Z. Ltd. among the existing Shareholders)		60,000	60,000

In the books of Z Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c Dr. To Liquidator of X Ltd A/c To Liquidator of Y Ltd A/c (Being the amount payable to the liquidators of X Ltd and Y Ltd. as per agreement dated . . .)		1,80,000	 1,20,000 60,000
	Land and Buildings A/c Dr. Plant and Machinery A/c Dr. Inventories A/c Dr. Sundry Debtors A/c Dr. Cash A/c Dr. To 6% Debentures in X Ltd A/c To Trade Creditors A/c To Employees P.F. A/c To General Reserve A/c [See Tutorial Note] To Profit and Loss A/c To Dividend Equalisation Fund A/c To Business Purchase A/c (Being the assets, liabilities, reserve, Profit and Loss Account taken over and the difference between the amount recorded as share capital issued and share capital of X Ltd adjusted against reserve))		30,000 1,10,000 16,000 14,000 3,000	 20,000 10,000 3,000 14,000 2,000 4,000 1,20,000
	Plant and Machinery A/c Dr. Inventories A/c Dr. Sundry Debtors A/c Dr. Cash A/c Dr.		50,000 8,000 9,000 1,000	

	To Trade Creditors A/c To Business Purchase A/c (Being the assets and liabilities taken over)			8,000 60,000
	Liquidator of X Ltd. A/c Dr. Liquidator of Y Ltd. A/c Dr. To Equity Share Capital A/c (Being the issue of 18,000 equity shares to transferor companies as fully paid-up for consideration other than cash)		1,20,000 60,000	 1,80,000
	6% Debentures in X Ltd. A/c Dr. To 6% Debentures A/c (Being the issue of necessary debentures to debentureholders of X Ltd.)		20,000	 20,000

Tutorial Note :
It should be noted that reserve, dividend equalisation fund, Profit and Loss Account will be carried forward in the books of Z Ltd. However, the difference between the amount recorded as share capital and the share capital of X Ltd will be adjusted against the General Reserve. The amount to be adjusted has been calculated as follows :

Particulars	₹
Amount recorded as Share Capital	1,20,000
Less: Share Capital of X Ltd	1,00,000
Amount to be adjusted in General Reserve	20,000
Reserve of X Ltd.	34,000
Less: Amount to be adjusted (as calculated above)	20,000
Balance of General Reserve to be shown in Balance Sheet of Z Ltd	14,000

Z Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,80,000
(b) Reserves and Surplus	(2)	20,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	20,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	18,000
(c) Other Current Liabilities	(5)	3,000
TOTAL		2,41,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	1,90,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables	(7)	24,000
(d) Cash and Cash Equivalents	(8)	23,000
(e) Other Current Assets	(9)	41,000
TOTAL		2,41,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
1,00,000 Equity Shares of ₹ 10 each	10,00,000
Issued and Subscribed Capital :	
18,000 Equity Shares of ₹ 10 each fully paid	1,80,000
(All the above shares have been allotted as fully paid for consideration other than cash	
(2) Reserve and Surplus	
General Reserve	14,000
Profit and Loss Account	2,000
Dividend Equalisation Fund	4,000
	20,000
(3) Long-term Borrowings	
Secured	
6% Debentures	20,000

(4) Trade Payables

Particulars	₹
Trade Creditors	18,000
(5) Other Current Liabilities	
Employees' P.F.	3,000
(6) Fixed Assets	
Tangible Assets :	
Land and Building	30,000
Plant and Machinery	1,60,000
	1,90,000
(7) Inventories	24,000
(8) Trade Receivables	
Sundry Debtors	23,000
(9) Cash and Cash Equivalents	
Cash	4,000

Working Notes :

Dr. **(1) Realisation Account** **Cr.**

Particulars	X Ltd. (₹)	Y Ltd. (₹)	Particulars	X Ltd. (₹)	Y Ltd. (₹)
To Land and Buildings A/c	30,000	—	By 6% Debentures A/c	20,000	—
To Plant and Machinery	1,10,000	50,000	By Employees' PF A/c	3,000	—
To Inventories A/c	16,000	8,000	By Trade Creditors A/c	10,000	8,000
To Sundry Debtors A/c	14,000	9,000	By Z Ltd A/c	1,20,000	60,000
To Cash A/c	3,000	1,000	By Sundry Shareholders A/c	20,000	—
	1,73,000	68,000		1,73,000	68,000

Illustration 5

The summarised Balance Sheets of A Ltd and B Ltd as at 1st April, 2016 are as under :

Balance Sheets of A Ltd. and B Ltd. as at 1st April, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	1,20,000	1,00,000
(b) Reserves and Surplus — Reserve		60,000	50,000
Profit and Loss Account		10,000	20,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Trade Payables — Creditors		30,000	10,000
TOTAL		2,20,000	1,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		1,40,000	1,20,000
(2) Current Assets :			
(a) Inventories		30,000	15,000
(b) Trade Receivables — Debtors		10,000	25,000
(d) Cash and Cash Equivalents — Cash and Bank		40,000	20,000
TOTAL		2,20,000	1,80,000

Notes to Accounts :

(1) Share Capital

Particulars	A Ltd. ₹	B Ltd. ₹
Authorised Capital :		
... Equity Shares of ₹ ... each	?	?
... Preference Shares of ₹ ... each	?	?
	?	?
Issued and Subscribed Capital :		
8,000 Equity Shares of ₹ 15 each fully paid	1,20,000	—
10,000 Equity Shares of ₹ 10 each fully paid	—	1,00,000
	1,20,000	1,00,000

The above two companies agree to amalgamate and form a new company AB Ltd on the following conditions:

1. AB Ltd will take over all the assets and liabilities of A Ltd and B Ltd.
2. The entire purchase consideration will be satisfied by the issue of 28,600 equity shares of ₹ 10 each of AB Ltd.
3. For the purpose of amalgamation, the value of each equity share is agreed at ₹ 25 and ₹ 12.50 for A Ltd and B Ltd respectively.
4. The creditors are to be paid off by AB Ltd.

You are required to :

(i) Pass journal entries to close the books of A Ltd and B Ltd.; (ii) Pass journal entries in the books of AB Ltd; and (iii) Prepare the Balance Sheet of AB Ltd.;

Solution

This is an amalgamation in the ***nature of merger*** because :

(i) AB Ltd will take over all the assets and liabilities of A Ltd and B Ltd.

(ii) The entire purchase consideration will be satisfied by issue of equity shares.

Allocation of Purchase Consideration

Number of shares : A Ltd 8,000 (₹ 1,20,000 / 15) B Ltd 10,000 (1,00,000 / 10)

Market value of shares : A Ltd — 8,000 × ₹ 25 = ₹ 2,00,000. B Ltd — 10,000 × ₹ 12.50 = ₹ 1,25,000.

The total purchase consideration is 28,600 × ₹ 10 = ₹ 2,86,000.

₹ 2,86,000 will be shared by A and B in the ratio of 2,00,000 : 1,25,000 or 8 : 5.

Therefore, A Ltd will get : ₹ 2,86,000 × 8/13 = ₹ 1,76,000. B Ltd will get : ₹ 2,86,000 × 5/13 = ₹ 1,10,000.

In the books of A Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Realisation A/c	Dr.		2,20,000	
	To Land and Buildings A/c				1,40,000
	To Inventories A/c				30,000
	To Debtors A/c				10,000
	To Cash and Bank A/c				40,000
	(Being the transfer of difference assets to Realisation Account as per the scheme of amalgamation)				
	Creditors A/c	Dr.		30,000	
	To Realisation A/c				30,000
	(Being the transfer of creditors to Realisation Account)				
	Equity Share Capital A/c	Dr.		1,20,000	
	Reserve A/c	Dr.		60,000	
	Profit and Loss A/c	Dr.		10,000	
	To Sundry Equity Shareholders A/c				1,90,000
	(Being the transfer of Share Capital, Reserve and Profit and Loss Account balance to Sundry Shareholders Account)				
	AB Ltd A/c	Dr.		1,76,000	
	To Realisation A/c				1,76,000
	(Being the purchase consideration due from AB Ltd.)				

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Sundry Equity Shareholders A/c	Dr.		14,000	
	To Realisation A/c (Note 1)				14,000
	(Being the loss on realisation transferred to Sundry Equity Shareholders Account)				
	Shares in AB Ltd A/c	Dr.		1,76,000	
	To AB Ltd A/c				1,76,000
	(Being the purchase consideration received from AB Ltd)				
	Sundry Equity Shareholders A/c	Dr.		1,76,000	
	To Shares in AB Ltd A/c				1,76,000
	(Being the distribution of shares in AB Ltd among the existing shareholders)				

In the books of B Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Realisation A/c	Dr.		1,80,000	
	To Land and Buildings A/c				1,20,000
	To Inventories A/c				15,000
	To Debtors A/c				25,000
	To Cash and Bank A/c				20,000
	(Being the transfer of different assets to Realisation Account as per the scheme of amalgamation)				
	Creditors A/c	Dr.		10,000	
	To Realisation A/c				10,000
	(Being the transfer of creditors to Realisation Account)				
	Equity Share Capital A/c	Dr.		1,00,000	
	Reserve A/c	Dr.		50,000	
	Profit and Loss A/c	Dr.		20,000	
	To Sundry Equity Shareholders A/c				1,70,000
	(Being the transfer of Share Capital, Reserve and Profit and Loss Account balance to Sundry Shareholders Account)				
	AB Ltd A/c	Dr.		1,10,000	
	To Realisation A/c				1,10,000
	(Being the purchase consideration due from AB Ltd.)				
	Sundry Equity Shareholders A/c	Dr.		60,000	
	To Realisation A/c (Note 1)				60,000
	(Being the loss on realisation transferred to Sundry Equity Shareholders Account)				
	Shares in AB Ltd A/c	Dr.		1,10,000	
	To AB Ltd A/c				1,10,000
	(Being the purchase consideration received from AB Ltd)				
	Sundry Equity Shareholders A/c	Dr.		1,10,000	
	To Shares in AB Ltd A/c				1,10,000
	(Being the distribution of shares in AB Ltd among the existing shareholders)				

In the books of AB Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		1,76,000	
	To Liquidator of A Ltd A/c				1,76,000
	(Being the amount payable to A Ltd as per agreement dated . . .)				
	Land and Buildings A/c	Dr.		1,40,000	
	Inventories A/c	Dr.		30,000	
	Debtors A/c	Dr.		10,000	
	Cash and Bank A/c	Dr.		40,000	
	To Reserve A/c [₹ 60,000 – (₹ 1,76,000 – 1,20,000)]				4,000
	To Profit and Loss A/c				10,000
	To Creditors A/c				30,000
	To Business Purchase A/c				1,76,000
	(Being the different assets and liabilities taken over and the difference between share capital issued and the amount of share capital of A Ltd., adjusted against reserves)				

Liquidator of A Ltd A/c	Dr.	1,76,000	
To Equity Share Capital A/c			1,76,000
(Being the issue of shares against purchase consideration)			
Business Purchase A/c	Dr.	1,10,000	
To Liquidator of B Ltd A/c			1,10,000
(Being the amount payable to B Ltd as per agreement dated . . .)			
Land and Buildings A/c	Dr.	1,20,000	
Inventories A/c	Dr.	15,000	
Debtors A/c	Dr.	25,000	
Cash and Bank A/c	Dr.	20,000	
To Reserve A/c [₹ 50,000 – (₹ 1,10,000 – 1,00,000)]			40,000
To Profit and Loss A/c			20,000
To Creditors A/c			10,000
To Business Purchase A/c			1,10,000
(Being the different assets and liabilities taken over and the difference between share capital issued and the share capital of B Ltd, adjusted against reserves)			
Liquidator of B Ltd A/c	Dr.	1,10,000	
To Equity Share Capital A/c			1,10,000
(Being the issue of shares against purchase consideration)			
Creditors A/c (₹ 30,000 + 10,000)	Dr.	40,000	
To Cash and Bank A/c			40,000
(Being the creditors paid off)			

AB Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,86,000
(b) Reserves and Surplus	(2)	74,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
TOTAL		3,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	2,60,000
(2) Current Assets :		
(a) Inventories	(4)	45,000
(b) Trade Receivables	(5)	35,000
(c) Cash and Cash Equivalents	(6)	20,000
TOTAL		3,60,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
28,600 Equity Shares of ₹ 10 each fully paid	2,86,000
(All the above shares have been issued for consideration other than cash)	

(3) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (₹ 1,40,000 + 1,20,000)	2,60,000
(4) Inventories (₹ 30,000 + 15,000)	45,000
(5) Intangible Assets	
Sundry Debtors (₹ 10,000 + 25,000)	35,000

(2) Reserve and Surplus		(6) Cash and Cash Equivalents	
Reserve (₹ 4,000 + 40,000)	44,000	Cash (₹ 40,000 + 20,000 – 40,000)	20,000
Profit and Loss Account (₹ 10,000 + 20,000)	30,000		
	74,000		

Working Notes :

Dr. **(1) Realisation Account** **Cr.**

Particulars	A Ltd. ₹	B Ltd. ₹	Particulars	A Ltd. ₹	B Ltd. ₹
To Land and Buildings A/c	1,40,000	1,20,000	By Creditors A/c	30,000	10,000
To Inventories A/c	30,000	15,000	By AB Ltd A/c (Purchase Consideration)	1,76,000	1,10,000
To Debtors A/c	10,000	25,000	By Sundry Equity Shareholders A/c	14,000	60,000
To Cash and Bank A/c	40,000	20,000			
	2,20,000	1,80,000		2,20,000	1,80,000

Illustration 6

The summarised Balance Sheets of A Ltd and B Ltd as at 1.4.2016 are as under :

Balance Sheets of A Ltd. and B Ltd. as at 1st April, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 10 each fully paid		1,50,000	1,00,000
(b) Reserves and Surplus — Profit and Loss Account		30,000	60,000
General Reserve		70,000	—
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		50,000	—
12% Debentures		—	1,00,000
(4) Current Liabilities :			
(a) Trade Payables		1,00,000	40,000
TOTAL		4,00,000	3,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		2,30,000	1,10,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		80,000	90,000
(c) Trade Receivables — Debtors		30,000	20,000
(d) Cash and Cash Equivalents — Cash and Bank		60,000	80,000
TOTAL		4,00,000	3,00,000

The above two companies agree to amalgamate and form a new company AB Ltd on the following conditions :
For both the companies —

(i) An exchange of 6 shares in AB Ltd of ₹ 10 each at par for every 5 shares.

(ii) 90% of the equity shareholders will be discharged by the issue of equity shares of AB Ltd. The balance 10% will be discharged by paying cash (All assets and liabilities are taken over at book value).

You are required to show :

(1) the calculation of purchase consideration;
(2) Ledger accounts to close the books;
(3) journal entries in the books of AB Ltd; and
(4) Opening Balance Sheet of AB Ltd.

Solution **Calculation of Purchase Consideration**

Particulars	A Ltd. ₹	Particulars	B Ltd. ₹
Equity Shares — 15,000 x 90% x 6/5 x ₹ 10	1,62,000	10,000 x 90% x 6/5 x ₹ 10	1,08,000
Cash — 15,000 x 10% x 6/5 x ₹ 10	18,000	10,000 x 10% x 6/5 x ₹ 10	12,000
Purchase consideration	1,80,000	**Purchase consideration**	1,20,000

In the books of A Ltd.

Realisation Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Plant and Machinery A/c	2,30,000	2016	By 10% Debentures A/c	50,000
Apr. 1	To Inventories A/c	80,000	Apr. 1	By Creditors A/c	1,00,000
	To Debtors A/c	30,000		By AB Ltd A/c (Purchase Consideration)	1,80,000
	To Cash and Bank A/c	60,000		By Sundry Equity Shareholders A/c (Loss on realisation)	70,000
		4,00,000			4,00,000

AB Ltd. Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	1,80,000	2016 Apr. 1	By Equity Shares in AB Ltd A/c	1,62,000
				By Cash A/c	18,000
		1,80,000			1,80,000

Equity Shares in AB Ltd. Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd A/c	1,62,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	1,62,000
		1,62,000			1,62,000

Cash Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd A/c	18,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	18,000
		18,000			18,000

Sundry Equity Shareholders Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	70,000	2016	By Equity Share Capital A/c	1,50,000
Apr. 1	To Equity Shares in AB Ltd A/c	1,62,000	Apr. 1	By Reserve A/c	70,000
"	To Cash A/c	18,000	"	By Profit and Loss A/c	30,000
		2,50,000			2,50,000

In the books of B Ltd.

Realisation Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Plant and Machinery A/c	1,10,000	2016	By 12% Debentures A/c	1,00,000
Apr. 1	To Inventories A/c	90,000	Apr. 1	By Creditors A/c	40,000
"	To Debtors A/c	20,000	"	By AB Ltd A/c (Purchase Consideration)	1,20,000
"	To Cash and Bank A/c	80,000	"	By Sundry Equity Shareholders A/c (Loss on realisation)	40,000
		3,00,000			3,00,000

AB Ltd. Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	1,20,000	2016 Apr. 1	By Equity Shares in AB Ltd A/c	1,08,000
				By Cash A/c	12,000
		1,20,000			1,20,000

Dr. Equity Shares in AB Ltd. Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd A/c	1,08,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	1,08,000
		1,08,000			1,08,000

Dr. Cash Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd A/c	12,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	12,000
		12,000			12,000

Dr. Sundry Equity Shareholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	40,000	2016 Apr. 1	By Equity Share Capital A/c	1,00,000
	To Equity Shares in AB Ltd A/c	1,08,000		By Profit and Loss A/c	60,000
	To Cash A/c	12,000			
		1,60,000			1,60,000

In the books of AB Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		1,80,000	
	To Liquidator of A Ltd A/c				1,80,000
	(Being the amount payable to liquidator of A Ltd as per agreement dated . . .)				
	Plant and Machinery A/c	Dr.		2,30,000	
	Inventories A/c	Dr.		80,000	
	Debtors A/c	Dr.		30,000	
	Cash and Bank A/c	Dr.		60,000	
	To 10% Debentures in A Ltd A/c				50,000
	To Reserve A/c [₹ 70,000 – (₹ 1,80,000 – 1,50,000)]				40,000
	To Profit and Loss A/c				30,000
	To Creditors A/c				1,00,000
	To Business Purchase A/c				1,80,000
	(Being the different assets and liabilities taken over and the difference between share capital issued and cash paid, and the amount of share capital of A Ltd., adjusted against reserves)				
	Liquidator of A Ltd A/c	Dr.		1,80,000	
	To Equity Share Capital A/c				1,62,000
	To Cash and Bank A/c				18,000
	(Being the issue of shares and payment of cash against purchase consideration)				
	10% Debentures in A Ltd A/c	Dr.		50,000	
	To 10% Debentures A/c				50,000
	(Being the debentureholders in A Ltd discharged by the issue of 10% debentures)				
	Business Purchase A/c	Dr.		1,20,000	
	To Liquidator of B Ltd A/c				1,20,000
	(Being the amount payable to liquidator of B Ltd as per agreement dated . . .)				
	Plant and Machinery A/c	Dr.		1,10,000	
	Inventories A/c	Dr.		90,000	
	Debtors A/c	Dr.		20,000	
	Cash and Bank A/c	Dr.		80,000	
	To 12% Debentures in B Ltd A/c				1,00,000
	To Profit and Loss A/c [₹ 60,000 – (₹ 1,20,000 – 1,00,000)				40,000
	To Creditors A/c				40,000
	To Business Purchase A/c				1,20,000
	(Being the different assets and liabilities taken over and the difference between share capital issued and cash paid, and the amount of share capital of B Ltd, adjusted against Profit and Loss Account)				

Liquidator of B Ltd A/c Dr.		1,20,000	
To Equity Share Capital A/c			1,08,000
To Cash and Bank A/c			12,000
(Being the issue of shares and payment of cash against purchase consideration)			
12% Debentures in B Ltd A/c Dr.		1,00,000	
To 12% Debentures A/c			1,00,000
(Being the debentureholders of B Ltd discharged by the issue of 12% debentures)			

AB Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,70,000
(b) Reserves and Surplus	(2)	1,10,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	1,50,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	1,40,000
TOTAL		6,70,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	3,40,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,70,000
(c) Trade Receivables	(7)	50,000
(d) Cash and Cash Equivalents	(8)	1,10,000
TOTAL		6,70,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ₹ ... each	?
	?
Issued and Subscribed Capital :	
27,000 Equity Shares of ₹ 10 each fully paid	2,70,000
(All the above shares have been issued for consideration other than cash)	

(2) Reserve and Surplus

Particulars	₹
General Reserve	40,000
Profit and Loss Account (₹ 30,000 + 40,000)	70,000
	1,10,000

(3) Long-term Borrowings

Particulars	₹
Secured :	
10% Debentures	50,000
12% Debentures	1,00,000
	1,50,000

(4) Trade Payables

Trade Creditors (₹ 1,00,000 + 40,000)	1,40,000

(5) Fixed Assets

Tangible Assets :	
Plant and Machinery (₹ 2,30,000 + 1,10,000)	3,40,000

(6) Inventories

Inventories (₹ 80,000 + 90,000)	1,70,000

(7) Trade Receivables

Sundry Debtors (₹ 30,000 + 20,000)	50,000

(6) Cash and Cash Equivalents

Cash (₹ 60,000 – 18,000 + 80,000 – 12,000)	1,10,000

Illustration 7

The summarised Balance Sheets of Sun Ltd and Moon Ltd as at 1.4.2016 are as follows :

Balance Sheets of Sun Ltd. and Moon Ltd. as at 1st April, 2016

Particulars	Note No.	Sun Ltd. (₹)	Moon Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital —			
Equity Shares of ₹ 10 each fully paid		3,00,000	2,50,000
11% Preference Shares of ₹ 10 each fully paid		—	1,50,000
(b) Reserves and Surplus —			
Profit and Loss Account		1,00,000	—
Reserves		1,20,000	—
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 12% Debentures		50,000	1,00,000
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		30,000	50,000
TOTAL		6,00,000	5,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		3,50,000	4,00,000
(2) Current Assets :			
(a) Inventories		1,00,000	30,000
(b) Trade Receivables — Sundry Debtors		1,25,000	70,000
(c) Cash and Cash Equivalents — Cash and Bank		25,000	50,000
TOTAL		6,00,000	5,50,000

The above two companies agree to amalgamate and form a new company Sunmoon Limited on the following conditions:

Sun Ltd

(i) For every 5 equity shares, 6 shares of Sunmoon Ltd of ₹ 10 each will be issued at par.

(ii) Debentureholders will be issued 12% debentures of Sunmoon Ltd of same amount and denomination.

Moon Ltd

(i) The holders of 11% preference shares will be allotted 4, 13% preference shares of ₹ 10 each of Sunmoon Ltd for every 5 preference shares held.

(ii) For every 5 equity shares, 6 shares of Sunmoon Ltd of ₹ 10 each will be issued at par.

(iii) Debentureholders will be issued 12% debentures of Sunmoon Ltd of same amount and denomination.

You are required to show :

(1) the calculation of purchase consideration;

(2) Ledger accounts to close the books of Sun Ltd and Moon Ltd.

(3) journal entries in the books of Sunmoon Ltd.; and

(4) Opening Balance Sheet of Sunmoon Ltd.

Solution

(1) Calculation of Purchase Consideration

Sun Ltd

Equity shareholders — 30,000 / 5 × 6 × ₹ 10 = ₹ 3,60,000.

Moon Ltd

	₹
11% Preference shareholders — 15,000 / 5 × 4 × ₹ 10	1,20,000
Equity shareholders — 25,000 / 5 × 6 × ₹ 10	3,00,000
	4,20,000

Tutorial Note :
It should be noted that consideration for debentureholders will not be included in the purchase consideration. These debentures will be taken over by Sunmoon Ltd and thereafter discharged by issuing new debentures in Sunmoon Ltd.

(2) In the books of Sun Limited

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Plant and Machinery A/c	3,50,000	2016	By 12% Debentures A/c	50,000
Apr. 1	To Inventories A/c	1,00,000	Apr. 1	By Sundry Creditors A/c	30,000
"	To Sundry Debtors A/c	1,25,000	"	By Sunmoon Ltd A/c (Purchase Consideration)	3,60,000
"	To Cash and Bank A/c	25,000	"	By Sundry Equity Shareholders A/c (Loss on realisation)	1,60,000
		6,00,000			6,00,000

Dr. **Sunmoon Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	3,60,000	2016 Apr. 1	By Equity Shares in Sunmoon Ltd A/c	3,60,000
		3,60,000			3,60,000

Dr. **Equity Shares in Sunmoon Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Sunmoon Ltd A/c	3,60,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	3,60,000
		3,60,000			3,60,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	1,60,000	2016	By Equity Share Capital A/c	3,00,000
Apr. 1	To Equity Shares in Sunmoon Ltd A/c	3,60,000	Apr. 1	By Profit and Loss A/c	1,00,000
				By Reserve A/c	1,20,000
		5,20,000			5,20,000

In the books of Moon Limited

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Plant and Machinery A/c	4,00,000	2016	By 12% Debentures A/c	1,00,000
Apr. 1	To Inventories A/c	30,000	Apr. 1	By Sundry Creditors A/c	50,000
	To Sundry Debtors A/c	70,000		By Sunmoon Ltd A/c (Purchase Consideration)	4,20,000
	To Cash and Bank A/c	50,000		By Preference Shareholders A/c (Discount on Payment)	30,000
	To Sundry Equity Shareholders A/c (Profit)	50,000			
		6,00,000			6,00,000

Dr. **Sunmoon Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	4,20,000	2016	By Preference Shares in Sunmoon Ltd A/c	1,20,000
Apr. 1			Apr. 1	By Equity Shares in Sunmoon Ltd A/c	3,00,000
		4,20,000			4,20,000

Dr. **Preference Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Preference Shares in Sunmoon Ltd A/c	1,20,000	2016	By 11% Preference Share Capital A/c	1,50,000
Apr. 1	To Realisation A/c	30,000	Apr. 1		
		1,50,000			1,50,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Equity Shares in Sunmoon Ltd A/c	3,00,000	2016	By Equity Share Capital A/c	2,50,000
Apr. 1			Apr. 1	By Realisation A/c (Profit on realisation)	50,000
		3,00,000			3,00,000

(3) In the books of Sunmoon Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		3,60,000	
	To Liquidator of Sun Ltd A/c				3,60,000
	(Being the amount payable to the liquidator of Sun Ltd as per agreement dated . . .)				
	Plant and Machinery A/c	Dr.		3,50,000	
	Inventories A/c	Dr.		1,00,000	
	Sundry Debtors A/c	Dr.		1,25,000	
	Cash and Bank A/c	Dr.		25,000	
	To 12% Debentures in Sun Ltd A/c				50,000
	To Profit and Loss A/c				1,00,000
	To Reserve A/c [₹ 1,20,000 – (3,60,000 – 3,00,000)]				60,000
	To Sundry Creditors A/c				30,000
	To Business Purchase A/c				3,60,000
	(Being the different assets and liabilities taken over and the difference between share capital issued and the amount of share capital of Sun Limited, adjusted against reserves)				
	Liquidator of Sun Ltd A/c	Dr.		3,60,000	
	To Equity Share Capital A/c				3,60,000
	(Being the issue of shares against purchase consideration)				
	Business Purchase A/c	Dr.		4,20,000	
	To Liquidator of Moon Ltd A/c				4,20,000
	(Being the amount payable to the liquidator of Moon Ltd as per agreement dated . . .)				
	Plant and Machinery A/c	Dr.		4,00,000	
	Inventories A/c	Dr.		30,000	
	Sundry Debtors A/c	Dr.		70,000	
	Cash and Bank A/c	Dr.		50,000	
	Reserve A/c (₹ 4,20,000 – ₹ 4,00,000)	Dr.		20,000	
	To 12% Debentures in Moon Ltd A/c				1,00,000
	To Sundry Creditors A/c				50,000
	To Business Purchase A/c				4,20,000
	(Being the different assets and liabilities taken over and the difference between share capital issued and the amount of share capital of Moon Limited transferred to reserves)				
	Liquidator of Moon Ltd A/c	Dr.		4,20,000	
	To Equity Share Capital A/c				3,00,000
	To 13% Preference Share Capital A/c				1,20,000
	(Being the issue of equity shares and preference shares against purchase consideration)				
	12% Debentures in Sun Ltd A/c	Dr.		50,000	
	12% Debentures in Moon Ltd A/c	Dr.		1,00,000	
	To 12% Debentures A/c				1,50,000
	(Being the issue of debentures to the Sun Ltd and Moon Ltd debentureholders)				

Sunmoon Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,80,000
(b) Reserves and Surplus	(2)	1,40,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	1,50,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	80,000
TOTAL		11,50,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	7,50,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,30,000
(c) Trade Receivables	(7)	1,95,000
(d) Cash and Cash Equivalents	(8)	75,000
TOTAL		11,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ₹ ... each	?
	?
Issued and Subscribed Capital :	
66,000 Equity Shares of ₹ 10 each fully paid	6,60,000
12,000, 13% Preference Shares of ₹ 10 each	1,20,000
(All the above shares have been issued for consideration other than cash)	
	7,80,000
(2) Reserve and Surplus	
Reserve (W.N.I.)	40,000
Profit and Loss Account	1,00,000
	1,40,000

(3) Long-term Borrowings

Particulars	₹
Secured :	
12% Debentures (₹ 50,000 + 1,00,000)	1,50,000
(4) Trade Payables	
Sundry Creditors (₹ 30,000 + 50,000)	80,000
(5) Fixed Assets	
Tangible Assets :	
Plant and Machinery (₹ 3,50,000 + 4,00,000)	7,50,000
(6) Inventories (₹ 1,00,000 + 30,000)	1,30,000
(7) Trade Receivables	
Sundry Debtors (₹ 1,25,000 + 70,000)	1,95,000
(8) Cash and Cash Equivalents	
Cash (₹ 25,000 + 50,000)	75,000

Working Note :

(1) Calculation of Reserve

			₹
Reserve from the Balance Sheet of Sun Ltd.			1,20,000
Less : Adjustment in case of Sun Ltd (₹ 3,60,000 – 3,00,000)		60,000	
Adjustment in case of Moon Ltd —			
Preference shareholders (₹ 1,20,000 – 1,50,000)	– 30,000		
Equity shareholders (₹ 3,00,000 – 2,50,000)	50,000	20,000	80,000
			40,000

Alternatively, ₹ 60,000 (Cr.) of Sun Ltd. and ₹ 20,000 (Dr.) of Moon Ltd. = ₹ **40,000 (Cr.)**

Illustration 8

Super Express Ltd and Fast Express Ltd were in competing business. They decided to form a new company named Super Fast Express Ltd. The Balance Sheets of both the companies were as under :

Balance Sheets of Super Express Ltd. and First Express Ltd. as at 31st March, 2016

Particulars	Note No.	Super Express Ltd. (₹)	First Express Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		20,00,000	10,00,000
(b) Reserves and Surplus —			
Capital Reserve		1,00,000	—
General Reserve		—	1,00,000
Profit and Loss Account		—	1,00,000

(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Sundry Creditors		60,000	40,000
(c) Other Current Liabilities —			
Provident Fund		1,00,000	—
Employee Profit Sharing Account		—	60,000
TOTAL		22,60,000	13,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets —			
Buildings		10,00,000	6,00,000
Machinery		4,00,000	5,00,000
(ii) Intangible Assets — Goodwill		—	1,00,000
(2) Current Assets :			
(a) Current Investments			
(b) Inventories		3,00,000	40,000
(c) Trade Receivables — Sundry Debtors		2,40,000	40,000
(d) Cash and Cash Equivalents —			
Cash at Bank		2,20,000	10,000
Cash in Hand		1,00,000	10,000
TOTAL		22,60,000	13,00,000

The assets and liabilities of both the companies were taken over by the new company at their book values. The companies were allotted equity shares of ₹ 100 each in lieu of purchase consideration.

Prepare opening Balance Sheet of Super Fast Express Ltd as at 1st April, 2016. ***[C.A. (Inter) — Adapted]***

Solution

Since the assets and liabilities of both the companies are taken over by Super Fast Express Ltd at book values and purchase consideration for both the companies are to be satisfied by the issue of equity shares, it is an amalgamation in the ***nature of merger***.

Assumption : It is assumed that the purchase consideration is equal to share capital of each transferor company.

Super Fast Express Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	30,00,000
(b) Reserves and Surplus	(2)	3,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	1,00,000
(c) Other Current Liabilities	(4)	1,60,000
TOTAL		35,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	25,00,000
(ii) Intangible Assets	(6)	1,00,000

(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	3,40,000
(c) Trade Receivables	(8)	2,80,000
(d) Cash and Cash Equivalents	(9)	3,40,000
TOTAL		35,60,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
30,000 Equity Shares of ₹ 100 each fully paid	30,00,000
(All the above shares have been allotted as fully paid for consideration other than cash)	

(2) Reserve and Surplus

Capital Reserve	1,00,000
General Reserve	1,00,000
Profit and Loss Account	1,00,000
	3,00,000

(3) Trade Payables

Sundry Creditors (60,000 + 40,000)	1,00,000

(4) Other Current Liabilities

Particulars	₹
Employees' Profit Sharing Account	60,000
Provident Fund	1,00,000
	1,60,000

(6) Fixed Assets

Tangible Assets :	
Building (₹ 10,00,000 + 6,00,000)	16,00,000
Machinery (₹ 4,00,000 + 5,00,000)	9,00,000
	25,00,000

(7) Inventories (₹ 3,00,000 + 40,000)	3,40,000

(8) Trade Receivables

Sundry Debtors (₹ 2,40,000 + 40,000)	2,80,000

(9) Cash and Cash Equivalents

Bank (₹ 2,20,000 + 10,000)	2,30,000
Cash (₹ 1,00,000 + 10,000)	1,10,000
	2,40,000

Illustration 9

The summarised Balance Sheets of A Ltd and B Ltd as at 1st April, 2016 are as under :

Balance Sheets of A Ltd. and B Ltd. as at 1st April, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		3,00,000	5,00,000
(b) Reserves and Surplus — General Reserve		1,80,000	1,80,000
Profit and Loss Account		1,90,000	1,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Creditors		30,000	20,000
TOTAL		7,00,000	8,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Buildings		5,00,000	4,50,000
(2) Current Assets :			
(a) Inventories		1,00,000	1,30,000
(b) Trade Receivables — Debtors		50,000	1,50,000
(c) Cash and Cash Equivalents		50,000	70,000
TOTAL		7,00,000	8,00,000

A new company, AB Ltd is formed to take over all the assets and liabilities of A Ltd and B Ltd., under the following terms and conditions :

1. For every 2 shares of A Ltd., 3 shares of ₹ 10 each of AB Ltd will be issued.
2. For every 5 shares of B Ltd., 6 shares of ₹ 10 each of AB Ltd will be issued.
3. There are fractions equaling 50 shares of A Ltd and 100 shares of B Ltd — for which cash has to be paid.

You are required to :

(i) Show the necessary ledger accounts to close the books of A Ltd and B Ltd.
(ii) Pass journal entries in the books of AB Ltd.
(iii) Prepare the Balance Sheet of AB Ltd., after amalgamation.

Solution **Calculation of Purchase Consideration**

Particulars	A Ltd. ₹	Particulars	B Ltd. ₹
Equity Shares — (30,000 – 50) / 2 x 3 x ₹ 10	4,49,250	Equity Shares — (50,000 – 100) / 5 x 6 x ₹ 10	5,98,800
Cash — (fraction of shares) 50 / 2 x 3 x ₹ 10	750	Cash — (fraction of shares) 100 / 5 x 6 x ₹ 10	1,200
Purchase consideration	4,50,000	**Purchase consideration**	6,00,000

(i) In the books of A Limited

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Land and Building A/c	5,00,000	2016	By Creditors A/c	30,000
Apr. 1	To Inventories A/c	1,00,000	Apr. 1	By AB Ltd A/c (Purchase Consideration)	4,50,000
"	To Debtors A/c	50,000	"	By Sundry Equity Shareholders A/c (Loss)	2,20,000
"	To Cash and Bank A/c	50,000			
		7,00,000			7,00,000

Dr. **AB Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	4,50,000	2016	By Equity Shares in AB Ltd A/c	4,49,250
Apr. 1			Apr. 1	By Cash A/c	750
		4,50,000			4,50,000

Dr. **Equity Shares in AB Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To AB Ltd A/c	4,49,250	2016	By Sundry Equity Shareholders A/c	4,49,250
Apr. 1			Apr. 1		
		4,49,250			4,49,250

Dr. **Cash Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To AB Ltd A/c	750	2016	By Sundry Equity Shareholders A/c	750
Apr. 1			Apr. 1		
		750			750

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	2,20,000	2016	By Equity Share Capital A/c	3,00,000
Apr. 1	To Equity Shares in AB Ltd A/c	4,49,250	Apr. 1	By Reserve A/c	1,80,000
"	To Cash A/c	750	"	By Profit and Loss A/c	1,90,000
		6,70,000			6,70,000

In the books of B Limited

Realisation Account

Dr. | | | | | Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Land and Building A/c	4,50,000	2016 Apr. 1	By Creditors A/c	20,000
"	To Inventories A/c	1,30,000	"	By AB Ltd A/c (Purchase Consideration)	6,00,000
"	To Debtors A/c	1,50,000	"	By Sundry Equity Shareholders A/c (Loss)	1,80,000
"	To Cash and Bank A/c	70,000			
		8,00,000			8,00,000

AB Ltd. Account

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	6,00,000	2016 Apr. 1	By Equity Shares in AB Ltd A/c	5,98,800
				By Cash A/c	1,200
		6,00,000			6,00,000

Equity Shares in AB Ltd. Account

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd A/c	5,98,800	2016 Apr. 1	By Sundry Equity Shareholders A/c	5,98,800
		5,98,000			5,98,800

Cash Account

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd A/c	1,200	2016 Apr. 1	By Sundry Equity Shareholders A/c	1,200
		1,200			1,200

Sundry Equity Shareholders Account

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	1,80,000	2016 Apr. 1	By Equity Share Capital A/c	5,00,000
"	To Equity Shares in AB Ltd A/c	5,98,800	"	By Reserve A/c	1,80,000
"	To Cash A/c	1,200	"	By Profit and Loss A/c	1,00,000
		7,80,000			7,80,000

It is an Amalgamation in the Nature of Merger because all the assets and liabilities have been taken over and the purchase consideration has been satisfied by the issue of shares (excepting for fractional shares). Therefore, pooling of interests method is to be abopted.

(ii) In the books of AB Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		4,50,000	
	To Liquidator of A Ltd A/c				4,50,000
	(Being the amount payable to the liquidator of A Ltd as per agreement dated . . .)				
	Land and Building A/c	Dr.		5,00,000	
	Inventories A/c	Dr.		1,00,000	
	Debtors A/c	Dr.		50,000	
	Cash and Bank A/c	Dr.		50,000	
	To General Reserve A/c [₹ 1,80,000 – (₹ 4,50,000 – 3,00,000)]				30,000
	To Profit and Loss A/c				1,90,000
	To Creditors A/c				30,000
	To Business Purchase A/c				4,50,000
	(Being the different assets and liabilities taken over and the difference between share capital issued and cash paid, and the amount of share capital of A Ltd, adjusted against reserves)				

Liquidator of A Ltd A/c	Dr.		4,50,000	
To Equity Share Capital A/c				4,49,250
To Cash and Bank A/c				750
(Being the issue of shares and payment of cash against purchase consideration)				
Business Purchase A/c	Dr.		6,00,000	
To Liquidator of B Ltd A/c				6,00,000
(Being the amount payable to liquidation of B Ltd as per agreement dated . . .)				
Land and Building A/c	Dr.		4,50,000	
Inventories A/c	Dr.		1,30,000	
Debtors A/c	Dr.		1,50,000	
Cash and Bank A/c	Dr.		70,000	
To General Reserve A/c [₹ 1,80,000 – (₹ 6,00,000 – 5,00,000)]				80,000
To Profit and Loss A/c				1,00,000
To Creditors A/c				20,000
To Business Purchase A/c				6,00,000
(Being the different assets and liabilities taken over and the difference between share capital issued and cash paid, and the amount of share capital of B Ltd, adjusted against reserves)				
Liquidator of B Ltd A/c	Dr.		6,00,000	
To Equity Share Capital A/c				5,98,800
To Cash and Bank A/c				1,200
(Being the issue of shares and payment of cash against purchase consideration)				

AB Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,48,050
(b) Reserves and Surplus	(2)	4,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	50,000
TOTAL		14,98,050
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	9,50,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	2,30,000
(c) Trade Receivables	(6)	2,00,000
(d) Cash and Cash Equivalents	(7)	1,18,050
TOTAL		14,98,050

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
1,04,805 Equity Shares of ₹ 10 each fully paid	10,48,050
(All the above shares have been issued for consideration other than cash)	
(2) Reserve and Surplus	
General Reserve (₹ 30,000 + 80,000)	1,10,000
Profit and Loss Account (₹ 1,90,000 + 1,00,000)	2,90,000
	4,00,000
(3) Trade Payables	
Sundry Creditors (₹ 30,000 + 20,000)	50,000

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (₹ 5,00,000 + 4,50,000)	9,50,000
(5) Inventories (₹ 1,00,000 + 90,000)	2,30,000
(6) Trade Receivables	
Sundry Debtors (₹ 50,000 + 1,50,000)	2,00,000
(6) Cash and Cash Equivalents	
Cash (₹ 50,000 – 750 + 70,000 – 1,200)	1,18,050

Inter-Company Debts and Inventories

Generally, amalgamation takes place in between companies having mutual dealings. Therefore, in practice, it is common to find inter- company indebtedness and inter-company stocks in case of amalgamation.

Mutual Indebtedness

There may be mutual indebtedness between the transferor company and the transferee company or between the transferor companies. No adjustment is required in the books of the transferor company, for the above debts. They are simply to close the books of account by transferring sundry debtors and sundry creditors to Realisation Account at book values.

However, in the books of the transferee company one adjustment entry is to be passed to reduce the Sundry Debtors Account and Sundry Creditors Account.

The entry will be (in the books of Transferee Company):

Sundry Creditors Account Dr.

To Sundry Debtors Account

Mutual Acceptances

Like mutual indebtedness, there may be mutual acceptances (drawing and acceptance of bills of exchange) between the transferor company and transferee company. No special entry is required in the books of the transferor companies for mutual acceptances.

However, in the books of the transferee company the following entry is to be passed to reduce Bills Receivable Account and Bills Payable Account.

Bills Payable Account Dr.

To Bills Receivable Account

Illustration 10

Star Ltd. is formed to take over Sun Ltd. and Moon Ltd. for ₹ 20,00,000 and ₹ 12,00,000 payable in equity shares of ₹ 10 each,. The Balance Sheet of two companies are given below :

Balance Sheets of Sun Ltd. and Moon Ltd. as at 1st April, 2016

Particulars	Note No.	Sun Ltd. (₹)	Moon Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		12,00,000	10,00,000
(b) Reserves and Surplus — Reserve		10,00,000	2,60,000

(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables —			
Creditors		3,50,000	1,80,000
Bills Payable		50,000	60,000
TOTAL		26,00,000	15,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
Land and Buildings		10,00,000	5,50,000
Plant and Machinery		2,50,000	1,50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		6,75,000	4,80,000
(c) Trade Receivables —			
Debtors		5,75,000	2,20,000
Bills Receivables		60,000	80,000
(d) Cash and cash equivalents — Cash and Bank		40,000	20,000
TOTAL		26,00,000	15,00,000

Note : Bills discounted by Moon Ltd. include ₹ 30,000 due from Sun Ltd.

Additional Information :

(a) Bills Payable of Sun Ltd. include ₹ 50,000 acceptances in favour of Moon Ltd. But Bills Receivable of Moon Ltd. includes ₹ 20,000 accepted by Sun Ltd.

(b) Sundry Debtors of Moon Ltd. include ₹ 25,000 due from Sun Ltd.

You are required to :

(i) Pass journal entries in the books of Sun Ltd.

(ii) Pass journal entries in the books of Star Ltd.

Solution

Star Ltd is formed to take over all the assets and liabilities of Sun Ltd and Moon Ltd. All the assets and liabilities will be taken over at book value and all the shareholders of Sun Ltd and Moon Ltd will become shareholders of Star Ltd. Therefore, it is an amalgamation in the ***nature of merger***.

In the books of Sun Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Realisation A/c	Dr.		26,00,000	
Apr. 1	To Land and Buildings A/c				10,00,000
	To Plant and Machinery A/c				2,50,000
	To Inventories A/c				6,75,000
	To Debtors A/c				5,75,000
	To Bills Receivable A/c				60,000
	To Cash and Bank A/c				40,000
	(Being different assets transferred to Realisation Account)				
	Creditors A/c	Dr.		3,50,000	
	Bills Payable A/c	Dr.		50,000	
	To Realisation A/c				4,00,000
	(Being different liabilities transferred to Realisation Account)				
	Star Ltd. A/c	Dr.		20,00,000	
	To Realisation A/c				20,00,000
	(Being the purchase consideration due from Star Ltd.)				

	Shares in Star Ltd. A/c Dr. To Star Ltd. A/c (Being the purchase consideration received from Star Ltd.)		20,00,000	 20,00,000
	Sundry Shareholders A/c Dr. To Realisation A/c (Being the loss on realisation transferred to Sundry Shareholders Account)		2,00,000	 2,00,000
	Share Capital A/c Dr. Reserve A/c Dr. To Sundry Shareholders A/c (Being the transfer of share capital and reserve to Sundry Shareholders Account)		12,00,000 10,00,000	 22,00,000
	Sundry Shareholders A/c Dr. To Shares in Star Ltd. A/c (Being the shares in Star Ltd. distributed amongst the Sundry Shareholders)		20,00,000	 20,00,000

In the books of Star Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2016 Apr. 1	Business Purchase A/c Dr. To Liquidator of Sun Ltd. A/c To Liquidator of Moon Ltd. A/c (Being the amount payable to Liquidator of Sun Ltd and Moon Ltd as per agreement dated . . .)		32,00,000	 20,00,000 12,00,000
	Land and Buildings A/c Dr. Plant and Machinery A/c Dr. Inventories A/c Dr. Debtors A/c Dr. Bills Receivable A/c Dr. Cash and Bank A/c Dr. To Creditors A/c To Bills Payable A/c To Reserve A/c [₹ 10,00,000 – (20,00,000 – 12,00,000)] To Business Purchase A/c (Being the different assets and liabilities of Sun Ltd taken over and the difference between the shares issued and share capital of Sun Ltd. has been adjusted against the reserve)		10,00,000 2,50,000 6,75,000 5,75,000 60,000 40,000	 3,50,000 50,000 2,00,000 20,00,000
	Land and Buildings A/c Dr. Plant and Machinery A/c Dr. Inventories A/c Dr. Debtors A/c Dr. Bills Receivable A/c Dr. Cash and Bank A/c Dr. To Creditors A/c To Bills Payable A/c To Reserve A/c [2,60,000 – (12,00,000 – 10,00,000)] To Business Purchase A/c (Being the different assets and liabilities of Moon Ltd taken over and the difference between the shares issued and share capital of Moon Ltd. adjusted against reserve)		5,50,000 1,50,000 4,80,000 2,20,000 80,000 20,000	 1,80,000 60,000 60,000 12,00,000
	Liquidator of Sun Ltd. A/c Dr. Liquidator of Moon Ltd. A/c Dr. To Equity Share Capital A/c (Being the issue of equity shares to satisfy purchase consideration)		20,00,000 12,00,000	 32,00,000
	Creditors A/c Dr. To Debtors A/c (Being mutual indebtedness in between Sun Ltd. and Moon Ltd. set-off)		25,000	 25,000
	Bills Payable A/c (Note 1) Dr. To Bills Receivable A/c (Being mutual acceptances in between Sun Ltd. and Moon Ltd. set-off)		20,000	 20,000

Tutorial Note (1) : Although acceptance of Sun Ltd. includes 50,000 in favour of Moon Ltd. but Moon Ltd. holding only 20,000 and 30,000 has been discounted with the bank. Therefore, mutual acceptance will be set off ₹ 20,000.

Illustration 11

XY Ltd. is formed to take over X Ltd. and Y Ltd. for ₹ 4,00,000 and ₹ 3,00,000, payable in equity shares of ₹ 10 each. The Balance Sheets of two companies are given below :

Balance Sheets of X Ltd. and Y Ltd. as at 1st April, 2016

Particulars	Note No.	X Ltd. (₹)	Y Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		3,75,000	3,00,000
(b) Reserves and Surplus — Reserve		1,00,000	12,500
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables —			
Sundry Creditors		1,50,000	50,000
Bills Payable		25,000	37,500
TOTAL		6,50,000	4,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets —			
(i) Tangible assets :			
Land and Buildings		1,00,000	50,000
Plant and Machinery		1,12,500	37,500
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,75,000	75,000
(c) Trade Receivables			
Sundry Debtors		2,00,000	1,00,000
Bills Receivables		37,500	50,000
(d) Cash and Cash Equivalents — Cash at Bank		25,000	87,500
TOTAL		6,50,000	4,00,000

Note : Bills discounted by Y Ltd. not yet matured ₹ 7,500.

Additional information :

(i) Sundry Debtors of Y Ltd. include ₹ 25,000 due from X Ltd.; and

(ii) Bills payable of X Ltd. include ₹ 20,000 acceptances in favour of Y Ltd. But Bills receivable of Y Ltd. includes ₹ 12,500 accepted by X Ltd.

You are required to :

(i) pass the journal entries in the books of X Ltd. and Y Ltd.;

(ii) pass acquisition entries in the books of XY Ltd.; and

(iii) prepare Balance Sheet of XY Ltd.

Solution

In the books of X Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Realisation A/c	Dr.		6,50,000	
	To Land and Buildings A/c				1,00,000
	To Plant and Machinery A/c				1,12,500
	To Inventories A/c				1,75,000
	To Sundry Debtors A/c				2,00,000
	To Bills Receivable A/c				37,500
	To Cash and Bank A/c				25,000
	(Being different assets transferred to Realisation Account)				

	Sundry Creditors A/c Dr. Bills Payable A/c Dr. To Realisation A/c (Being different liabilities transferred to Realisation Account)		1,50,000 25,000	 1,75,000
	XY Ltd. A/c Dr. To Realisation A/c (Being the purchase consideration due from XY Ltd.)		4,00,000	 4,00,000
	Shares in XY Ltd. A/c Dr. To XY Ltd. A/c (Being the purchase consideration received from XY Ltd.)		4,00,000	 4,00,000
	Sundry Shareholders A/c Dr. To Realisation A/c (Being the loss on realisation transferred to Sundry Shareholders Account)		75,000	 75,000
	Share Capital A/c Dr. Reserve A/c Dr. To Sundry Shareholders A/c (Being the transfer of share capital and reserve to Sundry Shareholders Account)		3,75,000 1,00,000	 4,75,000
	Sundry Shareholders A/c Dr. To Shares in XY Ltd. A/c (Being the shares in XY Ltd. distributed amongst the Sundry Shareholders)		4,00,000	 4,00,000

In the books of Y Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2016 Apr. 1	Realisation A/c Dr. To Land and Buildings A/c To Plant and Machinery A/c To Inventories A/c To Sundry Debtors A/c To Bills Receivable A/c To Cash and Bank A/c (Being different assets transferred to Realisation Account)		4,00,000	 50,000 37,500 75,000 1,00,000 50,000 87,500
	Sundry Creditors A/c Dr. Bills Payable A/c Dr. To Realisation A/c (Being different liabilities transferred to Realisation Account)		50,000 37,500	 87,500
	XY Ltd. A/c Dr. To Realisation A/c (Being the purchase consideration due from XY Ltd.)		3,00,000	 3,00,000
	Shares in XY Ltd. A/c Dr. To XY Ltd. A/c (Being the purchase consideration received from XY Ltd.)		3,00,000	 3,00,000
	Sundry Shareholders A/c Dr. To Realisation A/c (Being the loss on realisation transferred to Sundry Shareholders Account)		12,500	 12,500
	Share Capital A/c Dr. Reserve A/c Dr. To Sundry Shareholders A/c (Being the transfer of share capital and reserve to Sundry Shareholders Account)		3,00,000 12,500	 3,12,500
	Sundry Shareholders A/c Dr. To Shares in XY Ltd. A/c (Being the shares in XY Ltd. distributed amongst the Shareholders)		3,00,000	 3,00,000

In the books of XY Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		7,00,000	
	To Liquidator of X Ltd. A/c				4,00,000
	To Liquidator of Y Ltd. A/c				3,00,000
	(Being the amount payable to Liquidator of X Ltd and Y Ltd as per agreement dated . . .)				
	Land and Buildings A/c	Dr.		1,00,000	
	Plant and Machinery A/c	Dr.		1,12,500	
	Inventories A/c	Dr.		1,75,000	
	Sundry Debtors A/c	Dr.		2,00,000	
	Bills Receivable A/c	Dr.		37,500	
	Cash and Bank A/c	Dr.		25,000	
	To Sundry Creditors A/c				1,50,000
	To Bills Payable A/c				25,000
	To Reserve A/c [₹ 1,00,000 – (4,00,000 – 3,75,000)]				75,000
	To Business Purchase A/c				4,00,000
	(Being the different assets and liabilities taken over and the difference between the shares issued and share capital of X Ltd. has been adjusted against the reserve)				
	Land and Buildings A/c	Dr.		50,000	
	Plant and Machinery A/c	Dr.		37,500	
	Inventories A/c	Dr.		75,000	
	Sundry Debtors A/c	Dr.		1,00,000	
	Bills Receivable A/c	Dr.		50,000	
	Cash and Bank A/c	Dr.		87,500	
	To Sundry Creditors A/c				50,000
	To Bills Payable A/c				37,500
	To Business Purchase A/c				3,00,000
	To Reserve A/c				12,500
	(Being the assets, liabilities and reserve taken over from Y Ltd.)				
	Liquidator of X Ltd. A/c	Dr.		4,00,000	
	Liquidator of Y Ltd. A/c	Dr.		3,00,000	
	To Equity Share Capital A/c				7,00,000
	(Being the issue of equity shares in satisfaction of purchase consideration)				
	Sundry Creditors A/c	Dr.		25,000	
	To Sundry Debtors A/c				25,000
	(Being mutual indebtedness in between X Ltd. and Y Ltd. set-off)				
	Bills Payable A/c (Note 1)	Dr.		12,500	
	To Bills Receivable A/c				12,500
	(Being mutual acceptances in between X Ltd. and Y Ltd. set-off)				

Tutorial Note :

(1) Although acceptance of X Ltd. include ₹ 20,000 in favour of Y Ltd., Y Ltd. has only ₹ 12,500 in hand. The balance has been discounted with the bank. Therefore, ₹ 7,500 is no longer a mutual liability, it is a liability to the bankers. Mutual acceptances still held ₹ 12,500 has been set-off.

XY Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,00,000
(b) Reserves and Surplus	(2)	87,500
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	2,25,000
TOTAL		10,12,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	3,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		2,50,000
(c) Trade Receivables	(5)	3,50,000
(d) Cash and Cash Equivalents		1,12,500
TOTAL		10,12,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	***
Issued and Subscribed Capital :	
70,000 Equity Shares of ₹ 10 each fully paid	7,00,000
[All shares have been allotted as fully paid-up, pursuant to a contract without payment being received in cash]	

(2) Reserve and Surplus

Particulars		₹
Reserve :		
X Ltd	75,000	
Y Ltd	12,500	87,500

(3) Trade Payables

Sundry Creditors	1,75,000
Bills Payable	50,000
	2,25,000

(4) Fixed Assets

Tangible Assets :	
Land and Building	1,50,000
Plant and Machinery	1,50,000
	3,00,000

(5) Trade Receivables

Bills Receivables	75,000
Trade Receivables (₹ 1,75,000 + 1,00,000)	2,75,000
	3,50,000

Inter-Company Inventories

Assets acquired by the transferee company may include inter company stock at inflated prices. At the time of passing entries in the books of the transferee company, the following adjustment entry is to be passed :

Reserve Account Dr.

To Inventories Account

However, no adjustment is required in the books of the transferor companies.

Illustration 12

On 1st April, 2016 XY Ltd. is formed to take over X Ltd. and Y Ltd. for ₹ 4,00,000 and ₹ 3,00,000 payable in Equity Shares of ₹ 10 each. The Balance Sheets of two companies as on 31st March, 2016 are given below :

Balance Sheets of X Ltd. and Y Ltd. as at 31st March, 2016

Particulars	Note No.	X Ltd. (₹)	Y Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 10 each		3,75,000	3,00,000
(b) Reserves and Surplus — General Reserve		1,00,000	12,500

(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables —			
Sundry Creditors		1,50,000	50,000
Bills Payable		25,000	37,500
TOTAL		6,50,000	4,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets —			
Land and Buildings		1,00,000	50,000
Plant and Machinery		1,12,500	37,500
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,75,000	75,000
(c) Trade Receivables —			
Sundry Debtors		2,00,000	1,00,000
Bills Receivables		37,500	50,000
(d) Cash and Cash Equivalents — Cash and Bank		25,000	87,500
TOTAL		6,50,000	4,00,000

Inventories of X Ltd. includes ₹ 20,000 purchased from Y Ltd. on which Y Ltd. made 20% profit on sales. Pass necessary Journal Entries in the books of XY Ltd. and also draft the Balance Sheet of XY Ltd.

Solution

In the books of XY Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		7,00,000	
	To Liquidator of X Ltd. A/c				4,00,000
	To Liquidator of Y Ltd. A/c				3,00,000
	(Being the amount payable to the liquidators of X Ltd and Y Ltd as per agreement dated . . .)				
	Land and Buildings A/c	Dr.		1,00,000	
	Plant and Machinery A/c	Dr.		1,12,500	
	Inventories A/c	Dr.		1,75,000	
	Sundry Debtors A/c	Dr.		2,00,000	
	Bills Receivable A/c	Dr.		37,500	
	Cash and Bank A/c	Dr.		25,000	
	To Sundry Creditors A/c				1,50,000
	To Bills Payable A/c				25,000
	To General Reserve A/c [₹ 1,00,000 – (4,00,000 – 3,75,000)]				75,000
	To Business Purchase A/c				4,00,000
	(Being assets, liabilities and reserve taken over from X Ltd. and the difference between the shares issued and share capital of X Ltd. has been adjusted against the reserve)				
	Land and Buildings A/c	Dr.		50,000	
	Plant and Machinery A/c	Dr.		37,500	
	Inventories A/c	Dr.		75,000	
	Sundry Debtors A/c	Dr.		1,00,000	
	Bills Receivable A/c	Dr.		50,000	
	Cash and Bank A/c	Dr.		87,500	
	To Sundry Creditors A/c				50,000
	To Bills Payable A/c				37,500
	To Business Purchase A/c				3,00,000
	To General Reserve A/c				12,500
	(Being the assets and liabilities taken over from Y Ltd. and purchase consideration agreed)				

	Liquidator of X Ltd. A/c	Dr.	4,00,000	
	Liquidator of Y Ltd. A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			7,00,000
	(Being the issue of equity shares in satisfaction of purchase consideration)			
	General Reserve A/c	Dr.	4,000	
	To Inventories A/c			4,000
	(Being the adjustment for inter-company stock)			

XY Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,00,000
(b) Reserves and Surplus	(2)	83,500
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	2,62,500
TOTAL		10,46,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	3,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	2,46,000
(c) Trade Receivables	(6)	3,87,500
(d) Cash and Cash Equivalents	(7)	1,12,500
TOTAL		10,46,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
70,000 Equity Shares of ₹ 10 each fully paid	7,00,000
(All the above shares have been issued for consideration other than cash)	

(2) Reserve and Surplus

Particulars	₹
General Reserve (₹ 75,000 + 12,500 – 4,000)	83,500

(3) Trade Payables

Particulars	₹
Sundry Creditors	2,00,000
Bills Payable	62,500
	2,62,500

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (₹ 1,00,000 + 50,000)	1,50,000
Plant and Building (₹ 1,12,500 + 37,500)	1,50,000
	3,00,000

Particulars	₹
(5) Inventories (₹ 2,50,000 – 4,000)	2,46,000

(6) Trade Receivables

Particulars	₹
Sundry Debtors	3,00,000
Bills Receivable	87,500
	3,87,500

(7) Cash and Cash Equivalents

Particulars	₹
Cash at Bank	1,12,500

Illustration 13

The summarised Balance Sheets of A Ltd and B Ltd at 1st April, 2016 are as under :

Balance Sheets of A Ltd. and B Ltd. as at 1st April, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,50,000	1,50,000
(b) Reserves and Surplus —			
General Reserve		60,000	40,000
Profit and Loss Account		40,000	60,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Creditors		30,000	20,000
TOTAL		3,80,000	2,70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		1,50,000	1,20,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		70,000	80,000
(c) Trade Receivables — Debtors		80,000	40,000
(d) Cash and Cash Equivalents — Cash and Bank		80,000	30,000
TOTAL		3,80,000	2,70,000

The above two companies agree to amalgamate and form a new company AB Ltd on the following conditions :

1. AB Ltd will take over all the assets and liabilities of A Ltd and B Ltd., subject to the following adjustments in order to ensure uniform accounting policies —
   (a) Though both the companies follow straight-line method of depreciation, A Ltd charges depreciation @ 10% p.a. whereas B Ltd charges depreciation @ 15% p.a. In effect, depreciation overcharged by B Ltd amount to ₹ 10,000 has to be adjusted.
   (b) A Ltd values stock on LIFO basis, whereas B Ltd values stock on FIFO basis. To bring B Ltd.'s values in line with those of A Ltd., its value is to be reduced by ₹ 5,000.
2. The entire purchase consideration will be satisfied by the issue of equity shares of ₹ 10 each. A Ltd will get 30,000 shares and B Ltd will get 20,000 shares.

You are required to : (i) close the books of A Ltd and B Ltd; (ii) Pass journal entries in the books of AB Ltd; and (iii) prepare the Balance Sheet of AB Ltd.

Solution

(i) In the books of A Ltd.

Realisation Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Fixed Assets A/c	1,50,000	2016	By Creditors A/c	30,000
Apr. 1	To Inventories A/c	70,000	Apr. 1	By AB Ltd. A/c (Purchase Consideration)	3,00,000
	To Debtors A/c	80,000		By Sundry Equity Shareholders A/c (Loss)	50,000
	To Cash and Bank A/c	80,000			
		3,80,000			3,80,000

Dr. **AB Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	3,00,000	2016 Apr. 1	By Equity Shares in AB Ltd. A/c	3,00,000
		3,00,000			3,00,000

Dr. **Equity Shares in AB Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd. A/c	3,00,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	3,00,000
		3,00,000			3,00,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	50,000	2016	By Equity Share Capital A/c	2,50,000
Apr. 1	To Equity Shares in AB Ltd. A/c	3,00,000	Apr. 1	By General Reserve A/c	60,000
				By Profit and Loss A/c	40,000
		3,50,000			3,50,000

In the books of B Ltd.

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Fixed Assets A/c (Note 1)	1,30,000	2016	By Creditors A/c	20,000
Apr. 1	To Inventories A/c (Note 2)	75,000	Apr. 1	By AB Ltd. A/c (Purchase Consideration)	2,00,000
	To Debtors A/c	40,000		By Sundry Equity Shareholders A/c	55,000
	To Cash and Bank A/c	30,000			
		2,75,000			2,75,000

Dr. **AB Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	2,00,000	2016 Apr. 1	By Equity Shares in AB Ltd. A/c	2,00,000
		2,00,000			2,00,000

Dr. **Equity Shares in AB Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To AB Ltd. A/c	2,00,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	2,00,000
		2,00,000			2,00,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	55,000	2016	By Equity Share Capital A/c	1,50,000
Apr. 1	To Equity Shares in AB Ltd. A/c	2,00,000	Apr. 1	By General Reserve A/c	40,000
				By Profit and Loss A/c (Note 3)	65,000
		2,55,000			2,55,000

Working Notes:

(1) For adjustment of excess depreciation, Fixed Assets Account will be debited and Profit and Loss Account will be credited by ₹ 10,000. After adjustment of depreciation, fixed assets balance will be ₹ 1,20,000 + ₹ 10,000 = ₹ **1,30,000**.

(2) For adjustment of stock value, Profit and Loss Account will be debited and Inventories Account will be credited by ₹ 5,000.

(3) Final balance of Profit and Loss Account will be : ₹ 60,000 + ₹ 10,000 – ₹ 5,000 = ₹ **65,000**.

(ii) In the books of AB Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Business Purchase A/c	Dr.		3,00,000	
Apr. 1	To Liquidator of A Ltd. A/c				3,00,000
	(Being the amount payable to the liquidator of A Ltd as per agreement dated . . .)				
	Fixed Assets A/c	Dr.		1,50,000	
	Inventories A/c	Dr.		70,000	
	Debtors A/c	Dr.		80,000	
	Cash and Bank A/c	Dr.		80,000	
	To General Reserve A/c [₹ 60,000 – (₹ 3,00,000 – 2,50,000)]				10,000
	To Profit and Loss A/c				40,000
	To Creditors A/c				30,000
	To Business Purchase A/c				3,00,000
	(Being different assets and liabilities taken over and the difference between share capital issued and the amount of share capital of A Ltd., adjusted against reserve)				
	Liquidator of A Ltd. A/c	Dr.		3,00,000	
	To Equity Share Capital A/c				3,00,000
	(Being the issue of shares against purchase consideration)				
	Business Purchase A/c	Dr.		2,00,000	
	To Liquidator of B Ltd. A/c				2,00,000
	(Being the amount payable to the liquidator of B Ltd as per agreement dated . . .)				
	Fixed Assets A/c (₹ 1,20,000 + 10,000)	Dr.		1,30,000	
	Inventories A/c (₹ 80,000 – 5,000)	Dr.		75,000	
	Debtors A/c	Dr.		40,000	
	Cash and Bank A/c	Dr.		30,000	
	To Reserve A/c (₹ 40,000 – 40,000) [Note 1]				Nil
	To Profit and Loss A/c (₹ 60,000 + 10,000 – 5,000 – 10,000] (Note 1)				55,000
	To Creditors A/c				20,000
	To Business Purchase A/c				2,00,000
	(Being different assets and liabilities taken over and the difference between share capital issued and the amount of share capital of B Ltd., adjusted against reserve and Profit and Loss Account)				
	Liquidator of B LLtd A/c	Dr.		2,00,000	
	To Equity Share Capital A/c				2,00,000
	(Being the issue of shares against purchase consideration)				

Working Note :

(1) The difference between share capital issued and the amount of share capital of B Ltd is ₹ 50,000 (₹ 2,00,000 – ₹ 1,50,000). ₹ 40,000 is adjusted against reserve and the balance of ₹ 10,000 is adjusted against Profit and Loss Account. Adjustment in respect of excess depreciation and change in the value of stock also to be made against the Profit and Loss Account balance.

AB Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus	(2)	1,05,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		

(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	50,000
TOTAL		6,55,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,80,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	1,45,000
(c) Trade Receivables	(6)	1,20,000
(d) Cash and Cash Equivalents	(7)	1,10,000
TOTAL		6,55,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	***
Issued and Subscribed Capital :	
50,000 Equity Shares of ₹ 10 each (All the shares have been allotted as fully paid up, pursuant to a contract without payment being received in cash)	5,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	10,000
Profit and Loss A/c	95,000
	1,05,000
(3) Trade Payable	
Creditors (₹ 30,000 + ₹ 20,000)	50,000
(4) Fixed Assets	
Tangible Assets (₹ 1,50,000 + ₹ 1,30,000)	2,80,000
(5) Inventories (₹ 70,000 + ₹ 75,000)	1,45,000
(6) Trade Receivables (₹ 80,000 + ₹ 40,000)	1,20,000
(7) Cash and Cash Equivalent (₹ 80,000 + ₹ 30,000)	1,10,000

Criticisms of Pooling of Interests Method

1. By ignoring the fair value of the assets of the transferor company, the transferee company has a lower depreciation and amortisation charge and therefore higher return on capital employed and earnings per share.
2. Pooling of interests method does not record any acquired asset, or liabilities that were not previously recorded and thus masks their presence.
3. Pooling of interests method may lead to "instant earnings" when combinations are consummated late in the fiscal year, because the earnings of the pooled companies are combined for the entire year.
4. Additional earning could be created if assets acquired in the pooling are sold at amounts considerably greater than their book values.
5. Under the pooling of interests method, readers of financial statement cannot tell how much was invested in the transctions, nor can they track the subsequent performance of the investment.
6. Some consider that there are no true mergers; one company inevitably dominates another.
7. All costs associated with amalgamation, e.g., accounting, legal and appraisal fees, are capital expenditure in nature. But without capitalising, these are adjusted against reserve. Therefore, the basic accounting principle is violated.
8. Whether the pooling of interests method or purchase method is used, the future cash flows are the same. The boost in earnings under pooling method reflects artificial accounting differences, rather than real economic differences.

Purchase Method

This method of accounting is applicable for ***Amalgamation in the Nature of Purchase***. The following points are important :

1. The assets and liabilities of the transferor company should be incorporated in the books of the transferee company either at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values on the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.
2. The reserves of the transferor company, other than statutory reserves, are not incorporated in the financial statements of the transferee company.
3. If the purchase consideration is greater than the net assets taken over of the transferor company, it should be treated as goodwill and debited to Goodwill Account.
   This goodwill will be amortised over a period not exceeding five years unless somewhat longer period can be justified.
   On the other hand, if the purchase consideration is less than the net assets taken over of the transferor company, it should be treated as Capital Reserve and credited to Capital Reserve Account.
4. Statutory Reserves of the transferor company (e.g., Development Allowance Reserve, or Investment Allowance Reserve) retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company.
5. Statutory Reserves are recorded in the financial statements of the transferee company by passing the following entry :

Amalgamation Adjustment Account	Dr.	[with the amount]
To Statutory Reserve Account		

Amalgamation Adjustment Account will be shown in the Balance Sheet of the transferee company as follows:

Reserve and Surplus :

Statutory Reserve	***	
Less: Amalgamation Adjustment Account	***	Nil

In this respect, it is important to know that '***Amalgamation Adjustment Account***' used to be shown under '***Miscellaneous Expenditure***' in the Companies Act, 1956. In the Companies Act, 2013 there is no scope of showing it under '***Miscellaneous Expenditure***'. Nowadays many companies are showing it under '***Reserve and Surplus***' in the above manner already shown.

When the identity of the statutory reserves is no longer required to be maintained, both the Reserves and the Adjustment accounts are ***reversed***.

Distinction between Pooling of Interests Method and Purchase Method

Sl. No.	Pooling of Interests Method	Sl. No.	Purchase Method
1.	This method is adopted in the case of Amalgamation in the nature of Merger	1.	This method is adopted in the case of Amalgamation in the Nature of Purchase.
2.	All assets, liabilities, reserves and surplus of the transferor company are incorporated in the financial statements of the transferee company at book value.	2.	Only assets and liabilities taken over from the transferor company are incorporated in the financial statements of the transferee company either at book value or agreed value.
3.	This method provides investors with less information.	3.	This method provides investors with more information.
4.	This method ignores the values exchanged in an amalgamation.	4.	This method reflects the values exchanged in an amalgamation

5.	This method does not record any acquired assets and liabilities that were not previously recorded in the books of the transferor company.	5.	This method reveals all hidden assets and liabilities of the transferor company by recording them at fair value in the books of the transferee company.
6.	The difference between the consideration and share capital of the transferor company is adjusted against reserves. No goodwill or capital reserve account emerges from this difference.	6.	The difference between the purchase consideration and the net assets taken over of the transferor company is recorded as goodwill or capital reserve, as the case may be.
7.	All costs associated with amalgamation are not capitalised but adjusted against reserve.	7.	All costs associated with amalgamation are capitalised.
8.	Under this method, no Amalgamation Adjustment Account is opened in the books of the transferee company.	8.	Under this method Amalgamation Adjustment Account must be opened in the books of the transferee company for carry forward of any "Statutory Reserve".

Accounting Entries in the Books of the Transferor Company

Journal Entries

1. For transferring different assets to Realisation Account

Realisation Account Dr.
To Sundry Assets Account [Individually, at book value]

Points to remember in this connection :

(a) ***For this purpose agreed valuations are absolutely immaterial.***
(b) ***If the cash in hand and cash at bank are not taken over by the transferee company, these should not be transferred to Realisation Account.***
(c) ***Other assets, even if they are not taken by the transferee company, should also be transferred to Realisation Account.***
(d) ***Goodwill, Patents and Trademark, etc., are also transferred to Realisation Account.***

2. For transferring different liabilities to Realisation Account

Liabilities Account Dr. [Individually, at book values]
To Realisation Account

Points to remember in this connection :

(a) ***Items in the nature of 'Provisions' are to be transferred to Realisation Account only, e.g., Employees Provident Fund; Provision for Taxation, Pension Fund, Provision for Bad Debts, Provision for Depreciation, etc.***
(b) ***Items in the nature of 'Reserves' are not to be transferred to Realisation Account. These are transferred to Sundry Shareholders Account. Examples are : Dividend Equalisation Fund; Profit and Loss Account Credit Balance; Workmen Compensation Fund, etc.***
(c) ***If any liability is not taken over by the transferee company, that should not be transferred to Realisation Account. Any profit or loss on discharge of such liability is transferred to Realisation Account.***

3. For transferring Equity Share Capital, Reserve and Surplus, etc.

Equity Share Capital Account Dr.
General Reserve Account Dr.

Profit and Loss Account Dr.

To Sundry Shareholders Account

Note : Profit and Loss Account debit balance is transferred to Sundry Shareholders Account by debiting Sundry Shareholders Account and crediting Profit and Loss Account etc.

4. Like Equity Share Capital, Preference Share Capital is closed by transferring to Preference Shareholders Account. The entry for this will be :

Preference Share Capital Account Dr.

To Preference Shareholders Account

Note : If the preference shareholders are paid more or less than the amount due to them as per Balance Sheet, the difference is transferred to Realisation Account.

5. For purchase consideration due from transferee company

Transferee Company Account Dr.[Purchase consideration]

To Realisation Account

6. On receiving purchase consideration from the transferee company

Equity Shares in Transferee Company Account Dr.

Preference Shares in Transferee Company Account Dr.

Debentures in Transferee Company Account Dr.

To Transferee Company Account

7. Entries for liquidation expenses are passed as follows:

(i) If the liquidation expenses are borne by the transferor company

Realisation Account Dr.

To Bank Account

(ii) If the liquidation expenses are borne by the transferee company

[No Entry]

8. For realisation of assets not taken over by the transferee company

Bank Account Dr.

To Realisation Account

9. For discharge of liabilities not taken over by the transferee company

Liabilities Account Dr.

To Bank Account

Note : Any profit or loss on discharge of liabilities are transferred to Realisation Account.

10. For payment to preference shareholders

Preference Shareholders Account Dr.

To Preference Shares in Transferee Company Account

To Bank Account (If any)

11. For loss on realisation

Sundry Shareholders Account Dr.

To Realisation Account

12. For profit on realisation

Realisation Account Dr.

To Sundry Shareholders Account

13. For final payment to Equity Shareholders

Sundry Shareholders Account Dr.

To Equity Shares in Transferee Company Account

To Bank Account (If any) Account

Note : After payment to equity shareholders, all accounts in the books of the transferor company will be closed.

Accounting Entries in the Books of the Transferee Company

Journal Entries

1. On amalgamation of the business

Business Purchase Account	Dr.	[with purchase consideration]
To Liquidator of Transferor Company Account		

2. For assets and liabilities taken over

(i) ***If the net acquired asset is equal to purchase consideration***

Assets Account	Dr.	[Individually, at agreed values]
To Liabilities Account		[Individually]
To Business Purchase Account		[Purchase consideration]

(ii) ***If the net acquired asset is more than the purchase consideration***

Assets Account	Dr.	[Individually, at agreed values]
To Liabilities Account		[Individually]
To Business Purchase Account		[Purchase consideration]
To Capital Reserve Account		[Difference]

(iii) If the net acquired asset is less than the purchase consideration

Goodwill Account	Dr.	[Difference]
Assets Account	Dr.	[Individually, at agreed value]
To Liabilities Account		[Individually]
To Business Purchase Account		

3. When purchase consideration is satisfied

Liquidator of Transferor Company Account	Dr.
To Equity Share Capital Account	
To Securities Premium Account	
To Preference Share Capital Account	

4. When liquidation expenses are incurred

Goodwill Account	Dr.
To Bank Account	

5. When formation expenses are incurred

Preliminary Expenses Account	Dr.
To Bank Account	

6. When there are both goodwill and capital reserve, it can be set off against each other with lower value — only net amount will appear in the new Balance Sheet.

Capital Reserve Account	Dr.
To Goodwill Account	

7. When new shares/debentures are issued

(i) Bank Account	Dr.
To Share Application Account	
To Debenture Application Account	
(ii) Share Application Account	Dr.
Debenture Application Account	Dr.
To Share Capital Account	
To Debenture Account	

Note : We assume that all money is payable on application and shares are issued at par.

Illustration 14

A Ltd. and Z Ltd. are engaged in similar line of business.

They decided to amalgamate their business as on 1st April, 2016 by forming J Ltd., with an authorised share capital of ₹ 70,00,000; consisting of 6,00,000 Equity Shares of ₹ 10 each and 1,00,000, 9% Cumulative Preference Shares of ₹ 10 each.

The Balance Sheets of A Ltd. and Z Ltd. as on 31st March, 2016 are as follows :

Balance Sheets of A Ltd. and Z Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹)	Z Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		30,00,000	8,00,000
8% Preference Share of ₹ 10 each		10,00,000	—
(b) Reserves and Surplus —		16,00,000	—
General Reserve		1,80,000	64,000
Profit and Loss Account			
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Sundry Creditors		1,00,000	42,000
TOTAL		58,80,000	9,06,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets —			
Land and Buildings		12,00,000	—
Plant		31,00,000	—
Furnitures		—	1,90,000
Vehicles		—	80,000
(ii) Intangible Assets — Patents		4,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		7,00,000	4,78,000
(c) Trade Receivables — Debtors		1,60,000	1,24,000
(d) Cash and Cash Equivalents — Cash at Bank		3,20,000	34,000
TOTAL		58,80,000	9,06,000

The following terms were agreed upon by the parties :

(1) J Ltd. to allot 4,50,000 Equity shares @ ₹ 10 each to A Ltd., and pay cash ₹ 10,90,000 as consideration of whole of assets except bank balance.

(2) Z Ltd., is to receive 75,000 Equity shares @ ₹ 10 each and cash ₹ 12,000 as consideration for whole of assets except the bank balance.

(3) All assets are taken over at book value.

(4) J Ltd., is to issue remaining Equity shares and Preference shares at par for cash. This issue is fully subscribed and paid-up.

(5) Both A Ltd., and Z Ltd., are to pay other liabilities and Preference shareholders individually.

(6) J Ltd., is to pay and bear liquidation expenses of ₹ 10,000 for A Ltd., and ₹ 4,000 for Z Ltd. The formation expenses of J Ltd., is ₹ 36,000.

Show necessary journal entries in the books of A Ltd. and Z Ltd. Also pass the journal entries in the books of J Ltd and show the Balance Sheet of J. Ltd.

Solution **Calculation of Purchase Consideration**

Particulars	A. Ltd.	Z. Ltd.
(i) Equity Shares — 4,50,000 @ ₹ 10	45,00,000	
75,000 @ ₹ 10		7,50,000
(ii) Cash	10,90,000	12,000
	55,90,000	7,62,000

Note : Liquidation expenses are not included while calculating purchase consideration as per AS—14.

In the books of A Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Realisation A/c	Dr.		55,60,000	
April 1	To Land and Buildings A/c				12,00,000
	To Plant A/c				31,00,000
	To Patent A/c				4,00,000
	To Inventories A/c				7,00,000
	To Debtors A/c				1,60,000
	(Being the transfer of different assets to Realisation Account as per the scheme of amalgamation)				
	J. Ltd. A/c	Dr.		55,90,000	
	To Realisation A/c				55,90,000
	(Being the purchase consideration due from J. Ltd.)				
	Shares in J. Ltd. A/c	Dr.		45,00,000	
	Bank A/c	Dr.		10,90,000	
	To J. Ltd. A/c				55,90,000
	(Being the receipt of purchase consideration from J. Ltd.)				
	Sundry Creditors A/c	Dr.		1,00,000	
	8% Preference Share Capital A/c	Dr.		10,00,000	
	To Bank A/c				11,00,000
	(Being the payment of Sundry Creditors and 8% Preference Share Capital)				
	Equity Share Capital A/c	Dr.		30,00,000	
	General Reserve A/c	Dr.		16,00,000	
	Profit and Loss A/c	Dr.		1,80,000	
	To Sundry Shareholders A/c				47,80,000
	(Being the transfer of equity Share Capital, General Reserve and Profit and Loss balance to Sundry Shareholders Account)				
	Realisation A/c	Dr.		30,000	
	To Sundry Shareholders A/c				30,000
	(Being the profit on Realisation transferred to Sundry Shareholders Account)				
	Sundry Shareholders A/c	Dr.		48,10,000	
	To Shares in J. Ltd. A/c				45,00,000
	To Bank A/c				3,10,000
	(Being the final payment to shareholders)				

In the books of Z Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Realisation A/c	Dr.		8,72,000	
April 1	To Furnitures A/c				1,90,000
	To Vehicles A/c				80,000
	To Inventories A/c				4,78,000
	To Debtors A/c				1,24,000
	(Being the transfer of different assets to Realisation Account as per the scheme of amalgamation)				

	Particulars		L.F.	Dr. ₹	Cr. ₹
	J. Ltd. A/c	Dr.		7,62,000	
	To Realisation A/c				7,62,000
	(Being the purchase consideration due from J. Ltd.)				
	Shares in J. Ltd. A/c	Dr.		7,50,000	
	Bank A/c	Dr.		12,000	
	To J. Ltd. A/c				7,62,000
	(Being the receipt of purchase consideration from J. Ltd.)				
	Sundry Creditors A/c	Dr.		42,000	
	To Bank A/c				42,000
	(Being the Sundry Creditors paid off)				
	Equity Share Capital A/c	Dr.		8,00,000	
	Profit and Loss A/c	Dr.		64,000	
	To Sundry Shareholders A/c				8,64,000
	(Being the transfer of Equity Share Capital, Profit and Loss Account balance to Sundry Sharesholders Account)				
	Sundry Shareholders A/c	Dr.		1,10,000	
	To Realisation A/c				1,10,000
	(Being the loss on realisation transferred to Sundry Shareholders Account)				
	Sundry Shareholders A/c	Dr.		7,54,000	
	To Shares in J. Ltd. A/c				7,50,000
	To Bank A/c				4,000
	(Being the final payment to shareholders)				

Working Notes :

Dr. **(1) Realisation Account** **Cr.**

Date	Particulars	A Ltd. ₹	Z Ltd. ₹	Date	Particulars	A Ltd. ₹	Z Ltd. ₹
2016	To Land and Buildings A/c	12,00,000	—	2016	By J Ltd A/c	55,90,000	7,62,000
April 1	To Plant A/c	31,00,000	—	April 1	By Sundry Shareholders A/c	—	1,10,000
	To Furnitures A/c	—	1,90,000				
	To Vehicles A/c	—	80,000				
	To Patents A/c	4,00,000	—				
	To Inventories A/c	7,00,000	4,78,000				
	To Debtors A/c	1,60,000	1,24,000				
	To Sundry Shareholders A/c	30,000	—				
		55,90,000	8,72,000			55,90,000	8,72,000

Dr. **(2) Bank Account** **Cr.**

Date	Particulars	A Ltd. (₹)	Z Ltd. (₹)	Date	Particulars	A Ltd. (₹)	Z Ltd. (₹)
2016	To Balance b/d	3,20,000	34,000	2016	By 8% Pref. Share Capital A/c	10,00,000	—
April 1	To J Ltd. A/c	10,90,000	12,000	April 1	By Sundry Creditors A/c	1,00,000	42,000
					By Sundry Shareholders A/c	3,10,000	4,000
		14,10,000	46,000			14,10,000	46,000

In the books of J Ltd.

Journal **Dr.** **Cr.**

Date	Particulars		L.F.	₹	₹
2016	Business Purchase A/c	Dr.		63,52,000	
Mar. 31	To Liquidator of A Ltd A/c				55,90,000
	To Liquidator of Z Ltd A/c				7,62,000
	(Being the amount payable to the liquidators of A Ltd and Z Ltd)				
	Goodwill A/c (Balancing figure)	Dr.		30,000	
	Land and Buildings A/c	Dr.		12,00,000	
	Plant A/c	Dr.		31,00,000	
	Patents A/c	Dr.		4,00,000	

Inventories A/c Dr. Debtors A/c Dr. To Business Purchase A/c (Being the different assets taken over from A Ltd. The difference between the purchase consideration and net assets taken over transferred to Goodwill Account)			7,00,000 1,60,000	 55,90,000
Furnitures A/c Dr. Vehicles A/c Dr. Inventories A/c Dr. Debtors A/c Dr. To Business Purchase A/c To Capital Reserve A/c (Being the different assets taken over from Z Ltd. The difference between net assets taken over and purchase consideration transferred to Capital Reserve Account)			1,90,000 80,000 4,78,000 1,24,000	 7,62,000 1,10,000
Bank A/c Dr. To Equity Share Application A/c To 9% Cumulative Preference Share Application A/c (Being the application money received for 75,000 equity shares and 1,00,000 preference shares @ ₹ 10 each)			17,50,000	 7,50,000 10,00,000
Equity Share Application A/c Dr. 9% Cumulative Preference Share Application A/c Dr. To Equity Share Capital A/c To 9% Cumulative Preference Share Capital A/c (Being the issue of 75,000 equity shares of ₹ 10 each and 1,00,0000, 9% Cumulative Preference Shares of ₹ 10 each as fully paid as per Boards Resolution No. . . . dated . . .)			7,50,000 10,00,000	 7,50,000 10,00,000
Liquidator of A Ltd. A/c Dr. Liquidator of Z Ltd. A/c Dr. To Equity Share Capital A/c To Bank A/c (Being the purchase consideration paid-off)			55,90,000 7,62,000	 52,50,000 11,02,000
Goodwill A/c Dr. To Bank A/c (Being the liquidation expenses of ₹ 10,000 and ₹ 4,000 paid for A Ltd. and Z Ltd. respectively)			14,000	 14,000
Preliminary Expenses A/c Dr. To Bank A/c (Being formation expenses paid)			36,000	 36,000
Capital Reserve A/c Dr. To Goodwill A/c (₹ 30,000 + ₹ 14,000) (Being the goodwill adjusted against the Capital Reserve)			44,000	 44,000

J Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	70,00,000
(b) Reserves and Surplus	(2)	30,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		—
TOTAL		70,30,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	45,70,000
(ii) Intangible Assets	(4)	4,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	11,78,000
(c) Trade Receivables	(6)	2,84,000
(d) Cash and Cash Equivalents	(7)	5,98,000
TOTAL		70,30,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
6,00,000 Equity Shares of ₹ 10 each	60,00,000
1,00,000, 9% Cumulative Preference Shares of ₹ 10 each	10,00,000
	70,00,000
Issued and Subscribed Capital :	
6,00,000 Equity Shares of ₹ 10 each	60,00,000
1,00,000, 9% Cumulative Preference Shares of ₹ 10 each	10,00,000
(Of the above shares 5,25,000 equity shares of ₹ 10 each fully paid have been issued for consideration other than cash)	
	70,00,000

(2) Reserve and Surplus

Capital Reserve	66,000
Less: Preliminary Expenses	36,000
	30,000

(3) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building	12,00,000
Plant	31,00,000
Furnitures	1,90,000
Vehicles	80,000
	45,70,000

(4) Intangible Assets

Patent	4,00,000

(5) Inventories (7,00,000 + 4,78,000)	11,78,000

(6) Trade Receivables

Sundry Debtors	2,84,000

(7) Cash and Cash Equivalent

Bank (W.N. 1)	5,98,000

Working Notes :

Dr. **(1) Bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 April 1	To Equity Shares Application A/c	7,50,000	2016 April 1	By Liquidator of A Ltd A/c	10,90,000
	To 9% Cumulative Preference Share Application A/c	10,00,000		By Liquidator of Z Ltd A/c	12,000
			"	By Goodwill (Liquidation Expenses) A/c	14,000
			"	By Preliminary Expenses A/c	36,000
			"	By Balance c/d	5,98,000
		17,50,000			17,50,000

Illustration 15

Following is the summarised Balance Sheet of Y Ltd as at 31st March, 2016 :

Balance Sheet of Y Ltd. as at 31st March, 2016

Particulars	Note No.	mount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	30,00,000
(b) Reserves and Surplus —		
General Reserve		6,00,000
Profit and Loss Account		7,60,000
Workmen Profit Sharing Fund		3,00,000

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Creditors		4,00,000
TOTAL		50,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets —		
Building		7,00,000
Plant and Machinery		13,00,000
(ii) Intangible Assets — Goodwill		8,00,000
(2) Current Assets :		
(a) Inventories		7,00,000
(b) Trade Receivles — Sundry Debtors		9,00,000
(c) Cash and Cash Equivalents — Cash at Bank		6,60,000
TOTAL		50,60,000

X Ltd decided to absorb the business of Y Ltd on 1st April, 2016 at the respective book value of assets and trade liabilities except building which was valued at ₹ 12,00,000 and plant and machinery at ₹ 10,00,000,.

The purchase consideration was payable as follows :

(i) Payment of liquidation expenses ₹ 5,000 and workmen's profit sharing fund at 10% premium;

(ii) Issue of equity share of ₹ 10 each fully paid at ₹ 11 per share for every preference share and every equity share of Y Ltd and a payment of ₹ 4 per equity share in cash.

Calculate the purchase consideration, show the necessary ledger accounts in the books of Y Ltd and opening journal entries in the books of X Ltd *[C.A. (IPCC) — Adapted]*

Solution **(i) Calculation of Purchase Consideration**

Particulars		₹
(i) **Equity Shareholders** :		
Equity Shares (2,50,000 x ₹ 11)	27,50,000	
Cash (2,50,000 x ₹ 4)	10,00,000	
Workmen's Profit Sharing Fund (₹ 3,00,000 + 10% Premium)	3,30,000	40,80,000
(ii) **Preference Shareholders** :		
Equity Shares (1,00,000 x ₹ 11)		11,00,000
Total Purchase Consideration		51,80,000

Tutorial Note : Liquidation expenses of ₹ 5,000 will not be taken into consideration for calculation of purchase consideration.

In the books of Y Ltd

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Goodwill A/c	8,00,000	2016	By Creditors A/c	4,00,000
Apr. 1	To Building A/c	7,00,000	Apr. 1	By X Ltd A/c (Purchase Consideration)	51,80,000
	To Plant and Machinery A/c	13,50,000			
	To Inventories A/c	7,00,000			
	To Sundry Debtors A/c	9,00,000			
	To Bank A/c	6,60,000			
	To Workmen's Profit Sharing Fund A/c	30,000			
	To Preference Shareholdres A/c	1,00,000			
	To Equity Shareholders A/c (Profit)	3,90,000			
		55,80,000			55,80,000

Dr. **Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Equity Shares in X Ltd A/c	27,50,000	2016 Apr. 1	By Equity Share Capital A/c	20,00,000
	To Bank A/c	13,30,000		By General Reserve A/c	6,00,000
				By Workmen's Profit Sharing Fund A/c	3,30,000
				By Profit and Loss A/c	7,60,000
				By Realisation A/c (Profit)	3,90,000
		40,80,0000			40,80,000

Dr. **Shares in X Ltd Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To X Ltd A/c	38,50,000	2016 Apr. 1	By Equity Shareholders A/c	27,50,000
				By Preference Shareholders A/c	11,00,000
		38,50,000			38,50,000

Dr. **Workmen's Profit Sharing Fund Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Equity Shareholders A/c	3,30,000	2016 Apr. 1	By Balance b/d	3,00,000
				By Realisation A/c	30,000
		3,30,000			3,30,000

Dr. **Preference Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Equity Shares in X Ltd A/c	11,00,000	2016 Apr. 1	By Preference Share Capital A/c	10,00,000
				By Realisation A/c (Extra Payment)	1,00,000
		11,00,000			11,00,000

Dr. **Bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To X Ltd A/c	13,30,000	2016 Apr. 1	By Equity Shareholders A/c	13,30,000
		13,30,000			13,30,000

Dr. **X Ltd Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c (Purchase Consideration)	51,80,000	2016 Apr. 1	By Bank A/c	13,30,000
				By Equity Shares in X Ltd A/c	38,50,000
		51,80,000			51,80,000

(ii) In the books of X Ltd

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		51,80,000	
	To Liquidator of Y Ltd A/c				51,80,000
	(Being the amount payable to the liquidator of A Ltd as per agreement dated . . .)				
	Building A/c	Dr.		12,00,000	
	Plant and Machinery A/c	Dr.		10,00,000	
	Inventories A/c	Dr.		7,00,000	
	Sundry Debtors A/c	Dr.		9,00,000	
	Bank A/c	Dr.		6,60,000	
	Goodwill A/c (Balancing figure)	Dr.		11,20,000	
	To Creditors A/c				4,00,000
	To Business Purchase A/c				51,80,000
	(Being different assets and liabilities taken over. The difference between purchase consideration and net assets taken over transferred to Goodwill Account)				

Liquidator of Y Ltd A/c Dr. To Bank A/c To Equity Share Capital A/c To Securities Premium A/c (Being the discharge of purchase consideration by issuing 3,50,000 equity shares of ₹ 10 each at a premium of ₹ 1 per share. The balance amount paid by cheque)		51,80,000	 13,30,000 35,00,000 3,50,000
Goodwill A/c Dr. To Bank A/c (Being the liquidation expenses paid on behalf of Y Ltd)		5,000	 5,000

Illustration 16

Two companies Weak Ltd. and Feeble Ltd. amalgamate and form a new company Recovery Ltd. The Balance Sheets of two companies are as under :

Balance Sheets of Weak Ltd. and Feeble Ltd. as at ...

Particulars	Note No.	Weak Ltd. (₹)	Feeble Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ ... each		8,00,000	5,00,000
(b) Reserves and Surplus — Profit and Loss Account		1,00,000	2,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		1,20,000	—
(4) Current Liabilities :			
(a) Trade Payables — Creditors		1,80,000	1,00,000
TOTAL		12,00,000	8,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Intangible Assets — Goodwill		1,40,000	—
(2) Current Assets :			
(a) Trade Receivables — Debtors		3,10,000	3,00,000
(b) Cash and Cash Equivalents — Cash at Bank		7,50,000	5,00,000
TOTAL		12,00,000	8,00,000

The past average profits of Weak Ltd. and Feeble Ltd. were ₹ 60,000 and ₹ 40,000 respectively.

Recovery Ltd. agreed to take over the two companies for the sum of ₹ 15,00,000 and to discharge all liabilities. ₹ 3,00,000 of the purchase consideration be paid in cash and balance in equity shares. It is agreed that before being amalgamated, the debtors of the two companies will be written-down to the extent of 10%. The profit on conversion is to be divided between the two companies in the same proportion as to the profit previously earned by them.

Show Business Purchase Account in the books of Recovery Ltd. Also show how the Equity Shareholders Account of Weak Ltd. and Feeble Ltd. be closed.

Solution

It is an amalgamation in the **Nature of Purchase** because the purchase consideration has not been satisfied fully in equity shares. ₹ 3,00,000 was paid in cash out of total purchase consideration of ₹ 15,00,000.

Working Notes : **(1) Calculation of Goodwill / Capital Reserve**

Particulars	Weak Ltd.		Feeble Ltd.	
	₹	₹	₹	₹
Assets taken over :				
Inventories	3,10,000		3,00,000	
Debtors (less 10%)	6,75,000	9,85,000	4,50,000	7,50,000

Less : Liabilities taken over :				
10% Debentures	1,20,000		—	
Creditors	1,80,000	3,00,000	1,00,000	1,00,000
Net Assets taken over		6,85,000		6,50,000

Total net assets taken over = ₹ (6,85,000 + 6,50,000) = ₹ 13,35,000.
Purchase consideration = ₹ 15,00,000.
Profit on conversion = ₹ (15,00,000 – 13,35,000) = ₹ 1,65,000. This is also the goodwill paid by Recovery Ltd.
Again, profit sharing ratio between Weak Ltd and Feeble Ltd. is : ₹ 60,000 : ₹ 40,000 = 3 : 2.
Therefore, profit on conversion of ₹ 1,65,000 will be shared by the two companies as under :
Weak Ltd. — ₹ 1,65,000 × 3/5 = ₹ 99,000; Feeble Ltd. — ₹ 1,65,000 × 2/5 = ₹ 66,000.

(2) Calculation of Purchase Consideration of each Company

Particulars	Weak Ltd. ₹	Feeble Ltd. ₹
Net Assets taken over (as above)	6,85,000	6,50,000
Add : Profit on conversion	99,000	66,000
Purchase consideration	7,84,000	7,16,000

(3) Statement Showing Mode of Payment

The above purchase consideration will be satisfied as under assuming that the equity shares of Recovery Ltd. is divided equally and the balance by cash :

Particulars	Weak Ltd. ₹	Feeble Ltd. ₹
Equity Shares in Recovery Ltd. (equally)	6,00,000	6,00,000
Cash (Balancing figure)	1,84,000	1,16,000
	7,84,000	7,16,000

In the books of Recovery Ltd.

Dr. **Business Purchase Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To 10% Debentures in Weak Ltd. A/c	1,20,000		By Goodwill A/c	99,000
	To Creditors A/c	1,80,000		By Inventories A/c	3,10,000
	(Liabilities taken over from Weak Ltd.)			By Debtors A/c	6,75,000
	To Creditors A/c	1,00,000		(Net assets taken over from Weak Ltd.)	
	(Liabilities taken over from Feeble Ltd.)			By Goodwill A/c	66,000
	To Equity Share Capital A/c	12,00,000		By Inventories A/c	3,00,000
	To Bank A/c	3,00,000		By Debtors A/c	4,50,000
				(Net assets taken over from Feeble Ltd.)	
		19,00,000			19,00,000

In the books of Weak Ltd.

Dr. **Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Goodwill A/c (written-off)	1,40,000		By Equity Share Capital A/c	8,00,000
	To Debtors A/c (written-off)	75,000		By Profit and Loss A/c	1,00,000
	To Equity Shares in Recovery Ltd. A/c	6,00,000		By Realisation A/c (profit on conversion)	99,000
	To Bank A/c	1,84,000			
		9,99,000			9,99,000

In the books of Feeble Ltd.

Dr. **Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Debtors A/c (written-off)	50,000		By Equity Share Capital A/c	5,00,000
	To Equity Shares in Recovery Ltd. A/c	6,00,000		By Profit and Loss A/c	2,00,000
	To Bank A/c	1,16,000		By Realisation A/c (profit on conversion)	66,000
		7,66,000			7,66,000

Illustration 17

The abridged Balance Sheet of P Ltd. as at 31st March, 2016 is as under :

Balance Sheet of PLtd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 5,000 Equity Shares of ₹ 100 each		5,00,000
2,000, 10% Preference Shares of ₹ 100 each		2,00,000
(b) Reserves and Surplus — Profit and Loss Account		(2,95,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 15% Debentures		2,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Unsecured Loans		1,00,000
(b) Trade Payables — Creditors		1,50,000
(c) Other Current Liabilities — Accrued Interest on Debtors		30,000
TOTAL		8,85,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets —		
Freehold Premises		2,50,000
Machinery		1,35,000
(ii) Intangible Assets — Patents		70,000
(2) Current Assets :		
(a) Current Investments		
(b) Inventories		2,00,000
(c) Trade Receivables — Debtors		1,80,000
(d) Cash and Cash Equivalents — Bank balance		50,000
TOTAL		8,85,000

The following scheme of reconstruction was passed and approved by the court :

(i) A new company PK Ltd. to be formed to take over the entire business of P Ltd.

(ii) PK Ltd. to issue one equity share of ₹ 100, ₹ 60 paid-up in exchange of every two shares in P Ltd. to the shareholders who agree with the scheme. Shareholders, who do not agree with the scheme, to be paid @ ₹ 20 per share in cash. Such shareholders hold 400 equity shares.

(iii) Preference shareholders to get 15, 11% preference shares of ₹ 10 each in exchange of 2 preference shares of P Ltd.

(iv) Liability in respect of 15% debentures and interest accrued thereon to be taken over and discharged directly by PK Ltd. by issue of equity shares of ₹ 100 each fully paid-up.

(v) The creditors of P Ltd. will get from PK Ltd. 50% of their dues in cash and 25% in equity shares of ₹ 100 each and the balance to be foregone by them.

(vi) The freehold premises to be revalued at 20% more. The value of machinery to be reduced by $33^1/_3$% and that of debtors by 10%. The value of stock to be reduced to ₹ 1,60,000 and patents to have no value.

(vii) The preliminary expenses amounted to ₹ 5,000.

You are required to prepare necessary Ledger Accounts in the books of P Ltd. and pass opening journal entries in the books of PK Ltd.

Solution

Working Note : (1) Calculation of Purchase Consideration

Particulars	₹	₹
For Equity Shareholders :		
Equity Shares (5,000 – 4,000) / 2 x ₹ 60	1,38,000	
Cash (400 x ₹ 20)	8,000	1,46,000
For Preference Shareholders :		
11% Preference Shares (2,000 / 2 x 15 x ₹ 10)		1,50,000
Purchase Consideration		2,96,000

In the books of P Ltd.

Dr. Realisation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Patents A/c	70,000	2016	By 15% Debentures A/c	2,00,000
Apr. 1	To Freehold Premises A/c	2,50,000	Apr. 1	By Unsecured Loan A/c	1,00,000
	To Machinery A/c	1,35,000		By Creditors A/c	1,50,000
	To Inventories A/c	2,00,000		By Accrued Interest on Debentures A/c	30,000
	To Debtors A/c	1,80,000		By PK Ltd. A/c (Purchase consideration)	2,96,000
	To Bank A/c	50,000		By Preference Shareholders A/c	50,000
				By Equity Shareholders A/c (Loss on realisation)	59,000
		8,85,000			8,85,000

Dr. PK Ltd. Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	2,96,000	2016	By Equity Shares in PK Ltd. A/c	1,38,000
Apr. 1			Apr. 1	By Bank A/c	8,000
				By 11% Preference Shares in PK Ltd. A/c	1,50,000
		2,96,000			2,96,000

Dr. Preference Shareholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To 11% Preference Shares in PK Ltd. A/c	1,50,000	2016	By 10% Preference Share Capital A/c	2,00,000
Apr. 1	To Realisation A/c	50,000	Apr. 1		
		2,00,000			2,00,000

Dr. Equity Shareholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Profit and Loss A/c	2,95,000	2016	By Equity Share Capital A/c	5,00,000
Apr. 1	To Realisation A/c (Loss)	59,000	Apr. 1		
	To Equity Shares in PK Ltd. A/c	1,38,000			
	To Bank A/c	8,000			
		5,00,000			5,00,000

In the books of PK Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Business Purchase A/c	Dr.		2,96,000	
Apr. 1	To Liquidator of P Ltd A/c				2,96,000
	(Being the amount payable to the liquidator of P Ltd as per agreement dated . . .)				
	Freehold Premises A/c (₹ 2,50,000 + ₹ 50,000)	Dr.		3,00,000	
	Machinery A/c (₹ 1,35,000 – ₹ 45,000)	Dr.		90,000	
	Debtors A/c (₹ 1,80,000 – ₹ 18,000)	Dr.		1,62,000	

Inventories A/c	Dr.		1,60,000	
Bank A/c	Dr.		50,000	
To 15% Debentures in P Ltd. A/c				2,30,000
To Unsecured Loan A/c				1,00,000
To Creditors A/c (₹ 1,50,000 – ₹ 37,500)				1,12,500
To Business Purchase A/c				2,96,000
To Capital Reserve A/c				23,500
(Being the different assets and liabilities taken over)				
Liquidator of P Ltd. A/c	Dr.		2,96,000	
To Equity Share Capital A/c				1,38,000
To Bank A/c				8,000
To 11% Preference Share Capital A/c				1,50,000
(Being the discharge of purchase consideration)				
15% Debentures in P Ltd. A/c	Dr.		2,30,000	
To Equity Share Capital A/c				2,30,000
(Being 15% Debentures in P Ltd. discharged by the issue of 2,300 equity shares of ₹ 100 each fully paid-up)				
Creditors A/c	Dr.		1,12,500	
To Bank A/c				75,000
To Equity Share Capital A/c				37,500
(Being the creditors of P Ltd. paid-off)				
Capital Reserve A/c	Dr.		5,000	
To Bank A/c				5,000
(Being the preliminary expenses paid-off)				

Tutorial Note :
It is an amalgamation in the **Nature of Purchase** because the value of different assets and liabilities are to be adjusted.

Illustration 18

The Balance Sheet of Moon Limited as on 31st March, 2016 was as follows :

Balance Sheet of Moon Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 5,000 Equity Shares of ₹ 100 each		5,00,000
(b) Reserves and Surplus —		
Reserve		10,000
Profit and Loss Account		(1,65,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 9% Debentures		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		
(b) Trade Payables — Creditors		90,000
TOTAL		5,35,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets —		
Building		2,00,000
Plant		1,60,000
(2) Current Assets :		
(a) Inventories		30,000
(b) Trade Receivables — Debtors		1,20,000
(c) Cash and Cash Equivalents — Bank balance		25,000
TOTAL		5,35,000

On 1st April, 2016 Sun Limited was formed to take over the business of Moon Limited on the following terms :

(i) Debentures will be discharged by the issue of sufficient number of 12% Debentures of Sun Limited as would bring the same amount of interest.

(ii) Shareholders will be issued 2,400 Equity Shares of ₹ 100 each of Sun Limited.

(iii) Liquidation expenses of ₹ 2,000 will be paid by Sun Limited.

Prepare the necessary Ledger Accounts to close the books of Moon Limited.

Pass the opening journal entries in the books of Sun Limited and prepare the Balance Sheet of Sun Limited assuming that the assets of Moon Limited are taken over at 25% discount.

Solution

(i) Calculation of Purchase Consinderation

Particulars	₹
Equity Shares : 2,400 x ₹ 100	2,40,000
Issue of 12% debentures to pay-off 9% debentures is not to be included while calculating purchase consideration. Such debentures will be taken over by Sun Ltd. and then discharged. Likewise, liquidation expenses will also not to be included.	

(ii) Calculation of Goodwill / Capital Reserve

Particulars	₹	₹
Assets taken over :		
Building	1,50,000	
Plant	1,20,000	
Inventories	22,500	
Debtors	90,000	
Bank (Note 2)	25,000	4,07,500
Less: Liabilities taken over		
9% Debentures (Note 1)	75,000	
Creditors	90,000	1,65,000
		2,42,500
Less: Purchase Consideration		2,40,000
Capital Reserve		2,500

In the books of Moon Ltd.

Dr. Realisation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Building A/c	2,00,000	2016	By 9% Debentures A/c	1,00,000
Apr. 1	To Plant A/c	1,60,000	Apr. 1	By Creditors A/c	90,000
	To Inventories A/c	30,000		By Sun Ltd A/c (Purchase Consideration)	2,40,000
	To Debtors A/c	1,20,000		By Sundry Equity Shareholders A/c	1,05,000
	To Bank A/c	25,000		(Loss on realisation)	
		5,35,000			5,35,000

Dr. Sun Ltd. Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Realisation A/c	2,40,000	2016 Apr. 1	By Equity Shares in Sun Ltd A/c	2,40,000

Dr. Equity Shares in Sun Ltd. Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Sun Ltd A/c	2,40,000	2016 Apr. 1	By Sundry Equity Shareholders A/c	2,40,000

Dr. Sundry Equity Shareholders Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Profit and Loss A/c	1,65,000	2016	By Equity Share Capital A/c	5,00,000
Apr. 1	To Equity Shares in Sun Ltd A/c	2,40,000	Apr. 1	By Reserve A/c	10,000
	To Realisation A/c (Loss)	1,05,000			
		5,10,000			5,10,000

In the books of Sun Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Apr. 1	Business Purchase A/c	Dr.		2,40,000	
	To Liquidator of Moon Ltd A/c				2,40,000
	(Being the amount payable to Moon Ltd as per agreement dated . . .)				
	Building A/c	Dr.		1,50,000	
	Plant A/c	Dr.		1,20,000	
	Inventories A/c	Dr.		22,500	
	Debtors A/c	Dr.		90,000	
	Bank A/c	Dr.		25,000	
	To 9% Debentures in Moon Ltd A/c (Note 1)				75,000
	To Creditors A/c				90,000
	To Business Purchase A/c				2,40,000
	To Capital Reserve A/c				2,500
	(Being the different assets and liabilities taken over as per agreement dated . . . the difference between the net assets taken over and purchase consideration transferred to capital reserve)				
	Liquidator of Moon Ltd A/c	Dr.		2,40,000	
	To Equity Share Capital A/c				2,40,000
	(Being the purchase consideration discharged by the issue of 2,400 equity shares of ₹ 100 each)				
	9% Debentures in Moon Ltd A/c	Dr.		75,000	
	To 12% Debentures A/c				75,000
	(Being 9% debentures in Moon Ltd discharged by the issue of 12% debentures)				
	Capital Reserve A/c	Dr.		2,000	
	To Cash A/c				2,000
	(Being the liquidation expenses paid-off)				

Sun Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,40,000
(b) Reserves and Surplus	(2)	500
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	75,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	90,000
TOTAL		4,05,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,70,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	22,500
(c) Trade Receivables	(7)	90,000
(d) Cash and Cash Equivalents	(8)	23,000
TOTAL		4,05,500

Notes to Accounts :

Particulars	₹
(1) Share Capital	
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
2,400 Equity Shares of ₹ 100 each fully paid	2,40,000
(All the above shares have been issued for consideration other than cash)	
(2) Reserve and Surplus	
Capital Reserve (₹ 2,500 – 2,000)	500
(3) Long-Term Borrowings	
Secured :	
12% Debentures	75,000

Particulars	₹
(4) Trade Payables	
Creditors	90,000
(5) Fixed Assets	
Tangible Assets :	
Building	1,50,000
Plant	1,20,000
	2,70,000
(6) Inventories	22,500
(7) Trade Receivables	
Debtors	90,000
(8) Cash and Cash Equivalents	
Bank (₹ 25,000 – 2,000)	23,000

Working Notes :

(1) Face value of Debentures of Moon Ltd was ₹ 1,00,000. Interest payable @ 9%. Therefore, the debentureholders were getting interest of ₹ 9,000 (9% of ₹ 1,00,000).
Sun Ltd will issue 12% Debentures of such value which will result in same amount of interest. Therefore, the face value of 12% Debentures of Sun Ltd will be : ₹ 9,000 / 12 × 100 = ₹ **75,000**.
In the books of Sun Ltd., debentures will be recorded at ₹ 75,000 only.

(2) Bank will be taken at book value since it is a monetary asset.

Illustration 19

Following is the Balance Sheet of Star Ltd as on 31st March, 2016 :

Balance Sheet of Star Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,20,000 Equity Shares of ₹ 10 each		12,00,000
(b) Reserves and Surplus — Capital Reserve		20,000
Profit and Loss Account		(1,10,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Loan		3,60,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors		3,00,000
TOTAL		17,70,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		9,00,000
Furniture and Fittings		1,50,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		4,00,000
(c) Trade Receivables — Debtors		2,20,000
(d) Cash and Cash Equivalents — Bank Balance		1,00,000
TOTAL		17,70,000

On 1st April, 2016 a new company Suraj Ltd was incorporated which took over fixed assets and stock of Star Ltd for ₹ 12,60,000 payable as ₹ 9,00,000 in the form of 1,80,000 equity shares of ₹ 5 each and ₹ 3,60,000 in the form of 3,600, 12% Mortgage Debentures of ₹ 100 each. Lender accepted the debentures in Suraj Ltd in discharge of the loan. Debtors realised ₹ 2,05,000. Expenses of liquidation amounted to ₹ 8,000 and were met by Star Ltd. The available cash was distributed among creditors in full satisfaction of their claim.

Show necessary Ledger Accounts to close the books of Star Ltd and draw the opening Balance Sheet of Suraj Ltd.

Solution

(i) Calculation of Purchase Consideration

Particulars	₹
Equity Shares : 1,80,000 x ₹ 5	9,00,000
Issue of 12% mortgage debentures to pay-off loan is not to be included while calculating purchase consideration. Such loan will be taken over by Suraj Ltd. and then discharged.	

(ii) Calculation of Goodwill / Capital Reserve

Particulars	₹	₹
Assets taken over :		
Plant and Machinery	9,00,000	
Furniture and Fixture	1,50,000	
Inventories	4,00,000	14,50,000
Less: Liabilities taken over :		
Long-term Loan		3,60,000
Net Assets taken over		10,90,000
Less: Purchase Consideration		9,00,000
Capital Reserve		1,90,000

In the books of Star Ltd.

Realisation Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
2016 April 1	To Plant and Machinery A/c	9,00,000	2016 April 1	By Loan A/c	3,60,000
	To Furniture and Fixture A/c	1,50,000		By Suraj Ltd A/c	9,00,000
	To Inventories A/c	4,00,000		By Creditors A/c (Profit on payment)	3,000
	To Debtors A/c (Loss on realisation)	15,000		By Sundry Equity Shareholders A/c (Profit on realisation)	2,10,000
	To Bank A/c (Realisation expenses)	8,000			
		14,73,000			14,73,000

Suraj Ltd. Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
2016 April 1	To Realisation A/c	9,00,000	2016 April 1	By Equity Shares in Suraj Ltd A/c	9,00,000

Equity Shares in Suraj Ltd. Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
2016 April 1	To Suraj Ltd A/c	9,00,000	2016 April 1	By Equity Shareholders A/c	9,00,000

Debtors Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
2016 April 1	To Balance b/d	2,20,000	2016 April 1	By Bank A/c	2,05,000
				By Realisation A/c	15,000
		2,20,000			2,20,000

Bank Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
2016 April 1	To Balance b/d	1,00,000	2016 April 1	By Realisation A/c (expenses)	8,000
	To Debtors A/c	2,05,000		By Creditors A/c	2,97,000
		3,05,000			3,05,000

Creditors Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
2016 April 1	To Bank A/c	2,97,000	2016 April 1	By Balance c/d	3,00,000
	To Realisation A/c	3,000			
		3,00,000			3,00,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Profit and Loss A/c	1,10,000	2016	By Equity Share Capital A/c	12,00,000
April 1	To Equity Shares in Suraj Ltd A/c	9,00,000	April 1	By Capital Reserve A/c	20,000
	To Realisation A/c	2,10,000			
		12,20,000			12,20,000

Tutorial Note : It is an amalgamation in the ***Nature of Purchase*** because all the assets and liabilities are not taken over by the transferee company.

Suraj Ltd
Balance Sheet as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	9,00,000
(b) Reserves and Surplus	(2)	1,90,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	3,60,000
(4) Current Liabilities :		—
TOTAL		14,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	10,50,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	4,00,000
TOTAL		14,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
1,80,000 Equity Shares of ₹ 5 each fully paid	9,00,000
(All the above shares have been issued for consideration other than cash)	

(2) Reserve and Surplus

Particulars	₹
Capital Reserve (W.N. 1)	1,90,000

(3) Long-Term Borrowings

Particulars	₹
Secured :	
12% Mortgage Debentures	3,60,000

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	9,00,000
Furniture and Fixtures	1,50,000
	10,50,000
(5) Inventories	4,00,000

Illustration 20

The Balance Sheets of A Ltd and B Ltd as on 31st March, 2016 were as follows :

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹ '000)	B Ltd. (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	20,000	4,000
(b) Reserves and Surplus — General Reserve		8,000	—
Profit and Loss Account		900	320
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		500	210
TOTAL		29,400	4,530
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		6,000	—
Plant and Machinery		15,500	—
Motor Vehicles		—	400
Furniture		—	250
(ii) Intangible Assets :			
Goodwill		—	700
Patents		2,000	—
(2) Current Assets :			
(a) Current Investments		1,150	—
(b) Inventories		3,500	2,390
(c) Trade Receivables — Debtors		800	620
(d) Cash and Cash Equivalents0 — Cash at Bank		450	170
TOTAL		29,400	4,530

Notes to Accounts :

(1) Share Capital

Particulars	₹ ('000)	₹ ('000)
Issued, ubscribed and Paid-up Capital :		
15,00,000 Equity Shares of ₹ 10 each	15,000	—
[50,000 Preference Shares of ₹ 100 each	5,000	—
4,00,000 Equity Shares of ₹ 10 each	—	4,000
	20,000	4,000

A new company, C Ltd., was formed to acquire the assets and liabilities of A Ltd and B Ltd. The terms of acquisition of business were as under :

(1) C Ltd to have an authorised capital of ₹ 3,50,00,000 divided into 50,000, 13% preference shares of ₹ 100 each and 30,00,000 equity shares of ₹ 10 each.

(2) Business of A Ltd valued at ₹ 3,00,00,000; settlement being ₹ 60,00,000 cash and balance by issue of fully-paid equity shares at ₹ 12.

(3) Business of B Ltd valued at ₹ 48,00,000, to be satisfied by issue of fully-paid equity shares at ₹ 12.

(4) Preference shares of A Ltd were redeemed.

(5) C Ltd made a public issue of 30,000 preference shares at par and 3,00,000 equity shares at ₹ 12. The issue was underwritten at a commission of ₹ 1,65,000 and was fully subscribed. All obligations were met.

(6) D, who mooted the scheme, was allotted 40,000 equity shares (fully-paid) at ₹ 12 in consideration of his services.

Make journal entries in the books of A Ltd and B Ltd to close their books of account and prepare the Balance Sheet of C Ltd.

Solution

In the books of A Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹ ('000)	Cr. ₹ ('000)
2016 March 31	Realisation A/c	Dr.		2,94,00	
	To Patents A/c				20,00
	To Land and Building A/c				60,00
	To Plant and Machinery A/c				1,55,00
	To Investments A/c				11,50
	To Inventories A/c				35,00
	To Debtors A/c				8,00
	To Bank A/c				4,50
	(Being the transfer of different assets to Realisation Account as per the scheme of amalgamation)				
	Creditors A/c	Dr.		5,00	
	To Realisation A/c				5,00
	(Being the transfer of creditors to Realisation Account as per the scheme of amalgamation)				
	C Ltd A/c	Dr.		3,00,00	
	To Realisation A/c				3,00,00
	(Being the purchase consideration due from C Ltd)				
	Realisation A/c (Note 1)	Dr.		11,00	
	To Equity Shareholders A/c				11,00
	(Being the profit on realisation transferred to Equity Shareholders Account)				
	Equity Shares in C Ltd A/c	Dr.		2,40,00	
	Bank A/c	Dr.		60,00	
	To C Ltd A/c				3,00,00
	(Being the receipt of purchase consideration)				
	Preference Share Capital A/c	Dr.		50,00	
	To Preference Shareholders A/c				50,00
	(Being the preference share capital transferred to Preference Shareholders Account)				
	Preference Shareholders A/c	Dr.		50,00	
	To Bank A/c				50,00
	(Being the preference shareholders paid-off)				
	Equity Share Capital A/c	Dr.		1,50,00	
	General Reserve A/c	Dr.		80,00	
	Profit and Loss A/c	Dr.		9,00	
	To Equity Shareholders A/c				2,39,00
	(Being the transfer of equity share capital, general reserve, and Profit and Loss Account to Equity Shareholders Account)				
	Equity Shareholders A/c (₹ 1,100 + 23,900)	Dr.		2,50,00	
	To Equity Shares in C Ltd A/c				2,40,00
	To Bank A/c (₹ 6,000 – 5,000)				10,00
	(Being the final payment to equity shareholders)				

In the books of B Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹ ('000)	Cr. ₹ ('000)
2016 March 31	Realisation A/c	Dr.		45,30	
	To Goodwill A/c				7,00
	To Motor Vehicles A/c				4,00
	To Furniture A/c				2,50
	To Inventories A/c				23,90
	To Debtors A/c				6,20
	To Bank A/c				1,70
	(Being the transfer of different assets to Realisation Account as per the scheme of amalgamation)				

Creditors A/c Dr. To Realisation A/c (Being the transfer of creditors to Realisation Account as per the scheme of amalgamation)		2,10	2,10
C Ltd A/c Dr. To Realisation A/c (Being the purchase consideration due from C Ltd)		48,00	48,00
Realisation A/c (Note 1) Dr. To Equity Shareholders A/c (Being the profit on realisation transferred to Equity Shareholders Account)		4,80	4,80
Equity Shares in C Ltd A/c Dr. To C Ltd A/c (Being the receipt of purchase consideration)		48,00	48,00
Equity Share Capital A/c Dr. Profit and Loss A/c To Equity Shareholders A/c (Being the transfer of equity share capital and, profit and loss account to Equity Shareholders Account)		40,00 3,20	43,20
Equity Shareholders A/c Dr. To Shares in C Ltd A/c (Being the final payment to equity shareholders)		48,00	48,00

C Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹ '000)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,04,00
(b) Reserves and Surplus	(2)	48,35
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	7,10
TOTAL		3,59,45
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,21,50
(ii) Intangible Assets	(5)	42,80
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments	(6)	11,50
(2) Current Assets :		
(a) Inventories	(7)	58,90
(b) Trade Receivables	(8)	14,20
(c) Cash and Cash Equivalents	(9)	10,55
TOTAL		3,59,45

Notes to Accounts :

(1) Share Capital

Particulars	₹ '000
Authorised Capital :	
30,00,000 Equity Shares of ₹ 10 each	3,00,00
50,000, 13% Preference Shares of ₹ 100 each	50,00
	3,50,00
Issued and Subscribed Capital :	
27,40,000 Equity Shares of ₹ 10 each fully paid	2,74,00
30,000, 13% Preference Shares of ₹ 100 each	30,00
(Of the above shares 24,40,000 equity shares have been issued for consideration other than cash)	
	3,04,00

(2) Reserve and Surplus

Securities Premium	54,80
Underwriting Commission	(1,65)
Preliminary Expenses	(4,80)
	48,35

(3) Trade Payables

Particulars	₹ '000
Creditors	7,10
(4) Fixed Assets	
Tangible Assets :	
Land and Building	60,00
Plant and Machinery	1,55,00
Furniture	2,50
Motor Vehicles	4,00
	2,21,50
(5) Intangible Assets	
Goodwill (W.N.2)	22,80
Patents	20,00
	42,80
(6) Current Investments	11,50
(7) Inventories	58,90
(8) Trade Receivables	
Debtors	14,20
(9) Cash and Cash Equivalents	
Cash at Bank (W.N. 3)	10,500

Tutorial Note : It is an amalgamation in the ***Nature of Purchase*** because the purchase consideration has not been satisfied fully by issue of shares. Therefore, General Reserve and Profit and Loss Account balance of transferor companies will not be incorporated.

It should be noted that the shares have been issued by C Ltd (transferee company) at a premium to the liquidator of A Ltd and B Ltd.
Because of this, goodwill as well as securities premium will appear in the Balance Sheet of C Ltd simultaneously and these cannot be adjusted because of legal restrictions.
It would be a better accounting practice to issue shares at par. If this is done, existence of goodwill and securities premium can be avoided.

Working Notes :

Dr. **(1) Realisation Account** **Cr.**

Date	Particulars	A Ltd. ₹ ('000)	B Ltd. ₹ ('000)	Date	Particulars	A Ltd. ₹ ('000)	B Ltd. ₹ ('000)
	To Goodwill A/c	—	7,00		By Creditors A/c	5,00	2,10
	To Patents A/c	20,00	—		By C Ltd. A/c	3,00,00	48,00
	To Land and Building A/c	60,00	—				
	To Plant and Machinery A/c	1,55,00	—				
	To Motor Vehicles A/c	—	4,00				
	To Furniture A/c	—	2,50				
	To Investments A/c	11,50	—				
	To Inventories A/c	35,00	23,90				
	To Debtors A/c	8,00	6,20				
	To Cash at Bank A/c	4,50	1,70				
	To Equity Shareholders A/c	1,1,00	4,80				
		3,05,00	50,10			3,05,00	50,10

(2) Explanatory Journal (without narration)

Date	Particulars		L.F.	Dr. ₹ ('000)	Cr. ₹ ('000)
2016 Mar. 31	Goodwill A/c (Balancing figure)	Dr.		22,80	
	Patents A/c	Dr.		20,00	
	Land and Building A/c	Dr.		60,00	
	Plant and Machinery A/c	Dr.		1,55,00	
	Motor Vehicles A/c	Dr.		4,00	
	Furniture A/c	Dr.		2,50	
	Investments A/c	Dr.		11,50	
	Inventories A/c (₹ 35,00 + 23,90)	Dr.		58,90	
	Debtors A/c (₹ 800 + 6,20)	Dr.		14,20	
	Bank A/c (₹ 4,50 + 1,70)	Dr.		6,20	
	To Creditors A/c				7,10
	To Liquidator of A Ltd. A/c				3,00,00
	To Liquidator of B Ltd. A/c				48,00
	Liquidator of A Ltd. A/c	Dr.		3,00,00	
	Liquidator of B Ltd A/c	Dr.		48,00	
	To Equity Share Capital A/c				2,40,00
	To Securities Premium A/c				48,00
	To Bank A/c				60,00
	Bank A/c	Dr.		66,00	
	To Equity Share Capital A/c				30,00
	To Securities Premium A/c				6,00
	To Preference Share Capital A/c				30,00
	Underwriting Commission A/c	Dr.		1,65	
	To Bank A/c				1,65
	Preliminary Expenses A/c	Dr.		4,80	
	To Equity Share Capital A/c				4,00
	To Securities Premium A/c				80

(3) Cash at Bank : ₹ 4,50,000 + ₹ 1,70,000 + ₹ 66,00,000 – ₹ 60,00,000 – ₹ 1,65,000 = ₹ **10,55,000**.

Illustration 21

Given below are the Balance Sheets of two companies as on 31st March, 2016 :

Balance Sheet of M Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	20,00,000
(b) Reserves and Surplus — General Reserve		8,00,000
Profit and Loss Account		90,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		50,000
TOTAL		29,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		6,00,000
Plant and Machinery		15,50,000
(ii) Intangible Assets — Patent Rights		2,00,000

(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		3,50,000
(c) Trade Receivables — Sundry Debtors		80,000
(d) Cash and Cash Equivalents — Cash in Hand		1,60,000
TOTAL		29,40,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
1,50,000 Equity Shares of ₹ 10 each	15,00,000
50,000, 8% Cumulative Preference Shares of ₹ 10 each	5,00,000
	20,00,000

Balance Sheet of K Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 40,000 Equity Shares of ₹ 10 each		4,00,000
(b) Reserves and Surplus — Profit and Loss Account		32,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		21,000
TOTAL		4,53,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Motor Vehicles		40,000
Furniture		25,000
(ii) Intangible Assets — Goodwill		70,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		2,39,000
(c) Trade Receivables — Sundry Debtors		62,000
(d) Cash and Cash Equivalents		17,000
TOTAL		4,53,000

It has been agreed that both these companies should be wound up and a new company J K Ltd should be formed to acquire the assets of both the companies on the following terms :

(i) J K Ltd is to have an authorised capital of ₹ 30,00,000 divided into 50,000, 5% cumulative preference shares of ₹ 10 each and 2,50,000 equity shares of ₹ 10 each.

(ii) J K Ltd is to purchase the whole of the assets of M Ltd (except cash and bank balances) for ₹ 27,95,000 to be settled as to ₹ 5,45,000 in cash and as to the balance by issue of 1,80,000 equity shares, credited as fully paid, to be treated as valued at ₹ 12.50 each.

(iii) J K Ltd is to purchase the whole of the assets of K Ltd (except cash and bank balances) for ₹ 3,81,000 to be settled as to ₹ 6,000 in cash and as to the balance by issue of 30,000 equity shares, credited as fully paid, to be treated as valued at ₹ 12.50 each.

(iv) J K Ltd is to make a public issue of 50,000, 5% cumulative preference shares at par and 30,000 equity shares at the issue price of ₹ 12.50 per share, all payable in full on application.

(v) M Ltd and K Ltd both are to be wound up, the two liquidators distributing the shares in J K Ltd in kind among the equity shareholders of the respective companies.

(vi) The liquidator of M Ltd is to pay the preference shareholders ₹ 10 in cash for every share held in full satisfaction of their claims.

It is estimated that the costs of liquidation (including the liquidators' remuneration) will be ₹ 5,000 in case of M Ltd and ₹ 2,000 in the case of K Ltd and that the preliminary expenses of J K Ltd will amount to ₹ 18,000 exclusive of the underwriting commission of ₹ 23,750 payable on the public issue. The scheme has been sanctioned and carried through in its entirety.

You are required to :

(a) set out the closing entries in the books of M Ltd in the form of journal entries together with the closing cash book entries; and

(b) draw up the initial Balance Sheet of J K Ltd on the basis that all assets other than goodwill are taken over at the book value. ***[C.S. (Inter) — Adapted]***

Solution

(a) Calculation of Purchase Consideration

Particulars	₹
For Equity Shareholders :	
Cash	5,45,000
Equity Shares — 1,80,000 x ₹ 12.50	22,50,000
Purchase consideration	27,95,000

In the books of M Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Mar. 31	Realisation A/c	Dr.		27,80,000	
	To Patent Rights A/c				2,00,000
	To Land and Buildings A/c				6,00,000
	To Plant and Machinery A/c				15,50,000
	To Inventories A/c				3,50,000
	To Sundry Debtors A/c				80,000
	(Being the transfer of different assets to Realisation Account as per scheme of amalgamation)				
	J K Ltd. A/c	Dr.		27,95,000	
	To Realisation A/c				27,95,000
	(Being the purchase consideration due from J K Ltd.)				
	Equity Shares in J K Ltd. A/c	Dr.		22,50,000	
	To J K Ltd. A/c				22,50,000
	(Being the receipt of equity shares as part of the purchase consideration)				
	Preference Shares Capital A/c	Dr.		5,00,000	
	To Preference Shareholders A/c				5,00,000
	(Being preference share capital transferred to the Preference Shareholders Account)				
	Equity Share Capital A/c	Dr.		15,00,000	
	General Reserve A/c	Dr.		8,00,000	
	Profit and Loss A/c	Dr.		90,000	
	To Equity Shareholders A/c				23,90,000
	(Being the transfer of equity share capital, general reserve and, profit and loss balance to Equity Shareholders Account)				
	Realisation A/c (Note 1)	Dr.		10,000	
	To Equity Shareholders A/c				10,000
	(Being the profit on realisation transferred to Equity Shareholders Account)				
	Equity Shareholders A/c	Dr.		22,50,000	
	To Equity Shares in J K Ltd. A/c				22,50,000
	(Being the equity shares in J K Ltd. transferred to Equity Shareholders Account)				

Dr. **Cash Book** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Balance b/d	1,60,000	2016	By Sundry Creditors A/c	50,000
Mar. 31	To J K Ltd. A/c	5,45,000	Mar. 31	By Preference Shareholders A/c	5,00,000
				By Realisation A/c (Liquidation expenses)	5,000
				By Equity Shareholders A/c	1,50,000
		7,05,000			7,05,000

JK Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	29,00,000
(b) Reserves and Surplus	(2)	5,58,250
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
TOTAL		34,58,250
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	22,15,000
(ii) Intangible Assets	(4)	2,30,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	5,89,000
(c) Trade Receivables	(6)	1,42,000
(d) Cash and Cash Equivalents	(7)	2,82,250
TOTAL		34,58,250

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
2,50,000 Equity Shares of ₹ 10 each	25,00,000
50,000, 5% Preference Shares of ₹ 10 each	5,00,000
	30,00,000
Issued and Subscribed Capital :	
2,40,000 Equity Shares of ₹ 10 each	24,00,000
50,000, 5% Preference Shares of ₹ 10 each	5,00,000
(Of the above shares 2,10,000 equity shares of ₹ 10 each fully paid have been issued for consideration other than cash)	
	29,00,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium	6,00,000
Preliminary Expenses (Note 2)	(18,000)
Underwriting Commission (Note 2)	(23,750)
	5,58,250

(3) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building	6,00,000
Plant	15,50,000
Furnitures	25,000
Motor Vehicles	40,000
	22,15,000

(4) Intangible Assets

Particulars	₹
Goodwill	30,000
Patent Rights	2,00,000
	2,30,000

(5) Inventories

Particulars	₹
Inventories	5,89,000

(6) Trade Receivables

Particulars	₹
Sundry Debtors	1,42,000

(7) Cash and Cash Equivalent

Particulars	₹
Cash at Bank (W.N.3)	2,82,250

Working Note :

(1) Realisation Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
	To Sundry Assets A/c	27,80,000		By J K Ltd. A/c	27,95,000
	To Cash and Bank A/c (Liquidation Expenses)	5,000			
	To Equity Shareholders A/c (Profit)	10,000			
		27,95,000			27,95,000

Tutorial Note :

(1) No journal entry is required for payment to preference shareholders and creditors. All these entries are to be made in the Cash Book directly.

(2) Preliminary Expenses and Underwriting Commission can be adjusted against Securities Premium.

(2) Calculation of Goodwill / Capital Reserve and their Adjustments

Particulars	M Ltd. (₹)	K Ltd. (₹)
Net Assets taken over	27,80,000	4,36,000
Less: Purchase Consideration	27,95,000	3,81,000
Goodwill / Capital Reserve	(15,000)	55,000

Goodwill Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
	To Liquidator of K Ltd. A/c	70,000		By Capital Reserve A/c	55,000
	To Liquidator of M Ltd. A/c	15,000		By Balance c/d	30,000
		85,000			85,000

Capital Reserve Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
	To Goodwill A/c (adjusted)	55,000		By Liquidators of K Ltd. A/c	55,000

(3) Cash and Bank Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
	To 5% Cumulative Preference Share Application and Allotment A/c	5,00,000		By M Ltd. A/c	5,45,000
	To Equity Share Application and Allotment A/c	3,75,000		By K Ltd. A/c	6,000
				By Preliminary Expenses A/c	18,000
				By Underwriting Commission A/c	23,750
				By Balance b/d	2,82,250
		8,75,000			8,75,000

(4) Number of Equity Shares Issued by J K Ltd.

Particulars	Shares
(a) To M Ltd. (₹ 27,95,000 – ₹ 5,45,000) / ₹ 12.50	1,80,000
(b) To K Ltd. (₹ 3,81,000 – ₹ 6,000) / ₹ 12.50	30,000
(c) To Public	30,000
	2,40,000

Illustration 22

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 Balance Sheets of A Ltd and B Ltd as on 31st March, 2016 are given below :

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹ Lakhs)	B Ltd. (₹ Lakhs)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	1,100	950
(b) Reserves and Surplus	(2)	420	330

(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		60	30
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables :			
Sundry Creditors		270	120
Bills Payable		150	70
TOTAL		2,000	1,500
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
Land and Building		550	400
Plant and Machinery		350	250
(b) Non-current investments		150	50
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		350	250
(c) Trade Receivables — Sundry Debtors		250	300
Bills Receivanbles		50	50
(d) Cash and Cash Equivalents — Cash and Bank		300	200
TOTAL		2,000	1,500

Notes to Accounts :

(1) Share Capital

Particulars	A Ltd. (₹ Lakhs)	B Ltd. (₹ Lakhs)
Equity Shares of ₹ 100 each	800	750
12% Preference Shares of ₹ 100 each	300	200
	1,100	950
(2) Reserve and Surplus		
Revaluation Reserve	150	100
General Reserve	170	150
Investment Allowance Reserve	50	50
Profit and Loss	50	30
	420	330

Additional information :

(1) 10% Debentureholders 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 ₹ 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.

Solution

C Ltd
Balance Sheet as at 31st March, 2016

Particulars (1)	Note No. (2)	Amount (₹ in Lakhs) (3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,200
(b) Reserves and Surplus	(2)	1,650
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	60
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	610
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		3,520
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	1,550
(ii) Intangible Assets	(6)	20
(b) Non-current Investments		200
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	600
(c) Trade Receivables	(8)	650
(d) Cash and Cash Equivalents	(9)	500
TOTAL		3,520

Notes to Accounts :

(1) Share Capital

Particulars		₹ in Lacs
Authorised Capital :		
... Equity Shares of ₹ ... each		***
... Preference Shares of ₹ ... each		***
		***
Issued and Subscribed Capital :		
70,00,000 Equity Shares of ₹ 10 each fully paid		700
5,00,000, 15% Preference Shares of ₹ 100 each		500
		1,200

(2) Reserve and Surplus

Securities Premium (Note 5)		1,650
Investment Allowance Reserve (Note 4)	100	
Less: Amalgamation Adjustment Account (Note 4)	100	—
		1,650

(3) Long-term Borrowings

Secured Loans :	
15% Debentures	60

(4) Trade Payables

Sundry Creditors	390
Bills Payable	220
	610

(5) Fixed Assets

Particulars	₹ in Lacs
Tangible Assets :	
Land and Building	950
Plant and Machinery	600
	1,500

(6) Intangible Assets

Goodwill (110 – 90)	20

(7) Inventories (350 + 250)	600

(8) Trade Receivables

Sundry Debtors (250 + 300)	550
Bills Receivable (50 + 50)	100
	650

(9) Cash and Cash Equivalents

Cash and Bank (300 + 200)	500

Working Notes : **(1) Calculation of Purchase Consideration**

Particulars	A Ltd	B Ltd
	₹	₹
Preference shareholders :		
A Ltd — ₹ 3,00,00,000 / ₹ 100 x ₹ 150	450	
B Ltd — ₹ 2,00,00,000 / ₹ 100 x ₹ 150		300
Equity shareholders :		
A Ltd — ₹ 8,00,00,000 / ₹ 100 x 5 x ₹ 30	1,200	
B Ltd — ₹ 7,50,00,000 / ₹ 100 x 4 x ₹ 30		900
Purchase Consideration	1,650	1,200

(2) Calculation of Goodwill / Capital Reserve

Particulars	A Ltd		B Ltd	
	₹	₹	₹	₹
Assets taken over :				
Land and Building		550		400
Plant and Machinery		350		250
Investments		150		50
Inventories		350		250
Sundry Debtors		250		300
Bills Receivable		50		50
Cash and Bank		300		200
		2,000		1,500
Less: Liabilities taken over :				
Debentures (Note 3)	40		20	
Sundry Creditors	270		120	
Bills Payable	150	460	70	210
Net assets taken over		1,540		1,290
Less: Purchase Consideration (Note 1)		1,650		1,200
Goodwill (–) / Capital Reserve		(–) 110		90

(3) Interest paid on 10% Debentures of A Ltd = ₹ 60,00,000 × 10 / 100 = ₹ 6,00,000. To get the same amount of interest from 15% Debentures the face value of Debentures to be issued by C Ltd = ₹ 6,00,000 / 15 × ₹ 100 = ₹ 40,00,000.
Interest paid on 10% Debentures of B Ltd = ₹ 30,00,000 × 10 / 100 = ₹ 3,00,000. To get the same amount of interest from 15% Debentures the face value of Debentures to be issued by C Ltd = ₹ 3,00,000 / 15 × 100 = ₹ 20,00,000.

(4) Investment Allowance Reserve is to be maintained for 4 more years. As per the requirement of AS—14, it is to be carried forward by passing the following entry :

Amalgamation Adjustment Account Dr.
 To Investment Allowance Reserve Account

(5) Calculation of Securities Premium

Particulars	₹
For A Ltd : (3,00,000 Preference Shares x ₹ 50)	1,50,00,000
(8,00,000 Equity Shares x 5 x ₹ 20)	8,00,00,000
	9,50,00,000
For B Ltd : (2,00,000 Preference Shares x ₹ 50)	1,00,00,000
(7,50,000 Equity Shares x 4 x ₹ 20)	6,00,00,000
	7,00,00,000

Total Premium = ₹ 950 lakhs + 700 lakhs = ₹ **1,650 lakhs**.

Inter Company Invevestments

Amalgamation takes place between known companies. It may be noted that one company may hold some shares of another company. At the time of amalgamation some problems may arise according to situation.

Situation 1 : When one of the ***transferor*** company holding some shares of another transferor company.
Situation 2 : When the ***transferee*** company holding some shares of transferor company.
Situation 3 : When the ***transferor*** company holding some shares of transferee company.
We will discuss the above situations one by one.

Situation 1 : One of the transferor company holding shares of other transferor company

In this case, we should first close the books of account of that transferor company whose shares are held by another transferor company. For example, X Ltd and Y Ltd decide to amalgamate into XY Ltd. X Ltd holds 200 equity shares of ₹ 10 each fully paid of Y Ltd.

At the time of amalgamation, the books of account of Y Ltd are to be closed first in the usual manner. The liquidator of Y Ltd will pay-off its shareholders (including X Ltd for 200 shares) in the usual manner.

However, at the time of closing the books of account of X Ltd., Investment in Shares of Y Ltd Account will not be transferred to Realisation Account.

However, this account will be closed by passing the following entry:

Shares in XY Ltd Account Dr. [Shares received from liquidator of Y Ltd]
To Investment in Shares of Y Ltd Account

Any balance of Investment in Shares of Y Ltd Account will be transferred to Sundry Shareholders Account being profit/loss on realisation of Investment in Shares of Y Ltd.

Illustration 23

X Ltd. and Y Ltd. are two companies carrying on business in the same line of activity. Their Balance Sheets as on 31.03.2016 are given below :

Balance Sheets of X Ltd. and Y Ltd. as at 31st March, 2016

Particulars	Note No.	X Ltd. (₹)	Y Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 10 each fully paid		6,00,000	2,00,000
(b) Reserves and Surplus — General Reserve		4,00,000	2,00,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Secured Loans		6,00,000	1,00,000
(4) Current Liabilities :			
(a) Other Current Liabilities		6,00,000	4,00,000
TOTAL		22,00,000	9,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible assets :			
Land and Buildings		1,00,000	—
Plant and Machinery		7,00,000	3,00,000
(b) Non-current investments		1,00,000	—
(2) Current Assets :			
(a) Current Investments		—	
(b) Inventories		9,00,000	4,00,000
(c) Trade Receivables — Debtors		3,00,000	1,00,000
(d) Cash and Cash Equivalents — Cash at Bank		1,00,000	1,00,000
TOTAL		22,00,000	9,00,000

The two companies decide to amalgamate into XY Ltd. The following further information is given :

(1) X Ltd. holds 8,000 shares in Y Ltd. @ ₹ 12.50 each.
(2) All assets and liabilities of the two companies, except investments are taken over by XY Ltd.

(3) Each share in Y Ltd. is valued @ ₹ 25 for the purpose of the amalgamation.
(4) Shareholders in X Ltd. and Y Ltd. are paid-off by issuing to them sufficient number of Equity Shares of ₹ 10 each in XY Ltd. as fully paid-up at par.
(5) Each share in X Ltd. is valued @ ₹ 15 for the purpose of the amalgamation.

Show Journal Entries to close the books of both the companies.

Solution **Purchase Consideration**

X Ltd. — 60,000 shares @ ₹ 15 each = ₹ 9,00,000.
Y Ltd. — 20,000 shares @ ₹ 25 each = ₹ 5,00,000.

In this problem, X Ltd. holding 40% (8,000 shares out of 20,000 shares) of the share capital of Y Ltd. At the time of liquidation of Y Ltd., X Ltd. will get 40% of the amount payable to Sundry Shareholders of Y Ltd. Therefore, it is better to close the books of accounts of Y Ltd. first.

In the books of Y Ltd.
Journal **Dr.** **Cr.**

Date	Particulars		L.F.	₹	₹
2016	Realisation A/c	Dr.		9,00,000	
Mar. 31	To Plant and Machinery A/c				3,00,000
	To Inventories A/c				4,00,000
	To Debtors A/c				1,00,000
	To Cash A/c				1,00,000
	(Being the transfer of different assets to Realisation Account as per the Sch. of amalgamation)				
	Other Current Liabilities A/c	Dr.		4,00,000	
	Secured Loans A/c	Dr.		1,00,000	
	To Realisation A/c				5,00,000
	(Being the transfer of different liabilities to Realisation Account as per the Sch. of amalgamation)				
	XY Ltd. A/c	Dr.		5,00,000	
	To Realisation A/c				5,00,000
	(Being the purchase consideration due from XY Ltd. @ ₹ 25 per share on 20,000 shares)				
	Share Capital A/c	Dr.		2,00,000	
	General Reserve A/c	Dr.		2,00,000	
	To Sundry Shareholders A/c				4,00,000
	(Being the transfer of share capital and general reserve to Sundry Shareholders Account)				
	Realisation A/c	Dr.		1,00,000	
	To Sundry Shareholders A/c				1,00,000
	(Being profit on realisation transferred to Sundry Shareholders Account)				
	Shares in XY Ltd. A/c	Dr.		5,00,000	
	To XY Ltd. A/c				5,00,000
	(Being shares received from XY Ltd. against purchase consideration)				
	Sundry Shareholders A/c	Dr.		5,00,000	
	To Shares in XY Ltd. A/c				5,00,000
	(Being the distribution of shares in XY Ltd. among the existing shareholders)				

Working Note :

Dr. **Realisation Account** **Cr.**

Particulars	₹	Particulars	₹
To Plant and Machinery A/c	3,00,000	By Other Current Liabilities A/c	4,00,000
To Inventories A/c	4,00,000	By Secured Loans A/c	1,00,000
To Debtors A/c	1,00,000	By XY Ltd. A/c	5,00,000
To Cash A/c	1,00,000		
To Sundry Shareholders A/c	1,00,000		
	10,00,000		10,00,000

In the books of X Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Realisation A/c	Dr.		21,00,000	
Mar. 31	To Land and Building A/c				1,00,000
	To Plant and Machinery A/c				7,00,000
	To Inventories A/c				9,00,000
	To Debtors A/c				3,00,000
	To Cash at Bank A/c				1,,00,000
	(Being the transfer of different assets to Realisation Account on amalgamation with XY Ltd. as per the Scheme dated ....)				
	Other Current Liabilities A/c	Dr.		6,00,000	
	Secured Loans A/c	Dr.		6,00,000	
	To Realisation A/c				12,00,000
	(Being the transfer of different liabilities to Realisation Account on amalgamation with XY Ltd. as per the Scheme dated ....)				
	XY Ltd. A/c	Dr.		9,00,000	
	To Realisation A/c				9,00,000
	(Being the purchase consideration due from XY Ltd. @ ₹ 15 per share on 60,000 shares)				
	Shares in XY Ltd. A/c	Dr.		9,00,000	
	To XY Ltd. A/c				9,00,000
	(Being shares received from XY Ltd. against purchase consideration)				
	Share Capital A/c	Dr.		6,00,000	
	General Reserve A/c	Dr.		4,00,000	
	To Sundry Shareholders A/c				10,00,000
	(Being the transfer of share capital and general reserve to Sundry Shareholders Account)				
	Shares in XY Ltd. A/c (Note 2)	Dr.		2,00,000	
	To Investments A/c				1,00,000
	To Sundry Shareholders A/c (Tutorial Note)				1,00,000
	(Being the receipt of shares in XY Ltd. from the liquidator of Y Ltd. against 8,000 shares held in Y Ltd.; profit transferred to Sundry Shareholders Account)				
	Sundry Shareholders A/c	Dr.		11,00,000	
	To Shares in XY Ltd. A/c				11,00,000
	(Being the distribution of shares in XY Ltd. among the existing shareholders)				

Working Notes :

Dr. (1) Realisation Account Cr.

Particulars	₹	Particulars	₹
To Land and Building A/c	1,00,000	By Other Current Liabilities A/c	6,00,000
To Plant and Machinery A/c	7,00,000	By Secured Loans A/c	6,00,000
To Inventories A/c	9,00,000	By XY Ltd. A/c	9,00,000
To Debtors A/c	3,00,000		
To Cash and Bank A/c	1,00,000		
	21,00,000		21,00,000

(2) X Ltd. holding 8,000 shares of Y Ltd. From the liquidator of Y Ltd., X Ltd. will get ₹ 5,00,000 / 20,000 × 8,000 = ₹ 2,00,000. In the books of X Ltd. cost of investment is ₹ 1,00,000. Therefore, profit of ₹ 1,00,000 (₹ 2,00,000 – ₹ 1,00,000) is to be transferred to Sundry Shareholders Account.

Tutorial Note : Profit on realisation of investment in Y Ltd. can be transferred to Realisation Account in place of Sundry Shareholders Account.

Illustration 24

The following are the summarised Balance Sheets of M Ltd. and N Ltd.

Balance Sheets of M Ltd. and N Ltd. as at . . .

Particulars	Note No.	M Ltd. (₹)	N Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 10 each		40,000	20,000
(b) Reserves and Surplus — Profit and Loss Account		5,000	(1,000)
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings :			
Loan H Ltd.		10,000	—
Loan — M Ltd.		—	8,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		15,000	6,000
TOTAL		70,000	33,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Sundry Assets		42,000	33,000
(b) Non-current investments — Shares in N ltd.		20,000	—
(2) Current Assets :			
(e) Short-term Loans and Advances — Loans — N Ltd.		8,000	—
TOTAL		70,000	33,000

The whole of the shares of M Ltd. are held by H Ltd. and the entire share capital of N Ltd. is held by M Ltd.

A new company M N Ltd. is formed to acquire the sundry assets and creditors of M Ltd. and N Ltd. and for this purpose, the sundry assets of M Ltd. are revalued at ₹ 30,000 and those of N Ltd. at ₹ 20,000. The amount of the loan due to H Ltd. is also to be discharged in share in the new company; the debt due to M Ltd. is also to be similarly discharged.

Show the Journal Entries necessary to close the books of M Ltd. and N Ltd. ***[C.A. (Inter) — Adapted]***

Solution

In the books of N Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Realisation A/c	Dr.		33,000	
	To Sundry Assets A/c				33,000
	(Being the transfer of sundry assets to Realisation Account as per the scheme of amalgamation)				
	Creditors A/c	Dr.		6,000	
	To Realisation A/c				6,000
	(Being the transfer of crediters to Realisation Account as per the scheme of amalgamation)				
	Share Capital A/c	Dr.		20,000	
	To Sundry Shareholders (M Ltd.) A/c				20,000
	(Being the transfer of share capital to Sundry Shareholders Account)				
	MN Ltd. A/c (Note 1)	Dr.		14,000	
	To Realisation A/c				14,000
	(Being the purchase consideration due from MN Ltd.)				
	Sundry Shareholders (M Ltd.) A/c	Dr.		1,000	
	To Profit and Loss A/c				1,000
	(Being the debit balance of Profit and Loss Account transferred to Sundry Shareholders Account)				

	Shares in MN Ltd. A/c Dr. To MN Ltd. A/c (Being the amount of purchase consideration received in shares of MN Ltd.)		14,000	14,000
	Sundry Shareholders (M Ltd.) A/c Dr. To Realisation A/c (Being the loss on realisation transferred to Sundry Shareholders Account)		13,000	13,000
	Sundry Shareholders (M Ltd.) A/c Dr. Loan (M Ltd.) A/c Dr. To Shares in MN Ltd. A/c (Being the amount payable to shareholders and loan from M Ltd. discharged by issue of shares in MN Ltd.)		6,000 8,000	14,000

Working Notes : (1) Purchase consideration of N Ltd = Sundry assets – Creditors = ₹ 20,000 – ₹ 6,000 = ₹ 14,000.

Dr. (2) Realisation Account Cr.

Particulars	₹	Particulars	₹
To Sundry Assets A/c	33,000	By Creditors A/c	6,000
		By MN Ltd. A/c	14,000
		By Sundry Shareholders A/c (Loss)	13,000
	33,000		33,000

Dr. (3) Sundry Shareholders (M Ltd.) Account Cr.

Particulars	₹	Particulars	₹
To Profit and Loss A/c	1,000	By Share Capital A/c	20,000
To Realisation A/c	13,000		
To Shares in MN Ltd. A/c	6,000		
	20,000		20,000

Dr. (4) Loan — M Account Cr.

Particulars	₹	Particulars	₹
To Shares in MN Ltd. A/c	8,000	By Balance b/d	8,000
	8,000		8,000

In the books of M Ltd.

Journal **Dr. Cr.**

Date	Particulars	L.F.	₹	₹
	Realisation A/c Dr. To Sundry Assets A/c (Being the transfer of sundry assets to Realisation Account as per the scheme of amalgamation)		42,000	42,000
	Creditors A/c Dr. To Realisation A/c (Being the transfer of crediters to Realisation Account as per the scheme of amalgamation)		15,000	15,000
	MN Ltd. A/c (Note 1) Dr. To Realisation A/c (Being the purchase consideration due from MN Ltd.)		15,000	15,000
	Shares in MN Ltd. A/c Dr. To MN Ltd. A/c (Being the amount of purchase consideration received in shares of MN Ltd.)		15,000	15,000
	Shares in MN Ltd. A/c Dr. Realisation A/c (Note 2) Dr. To Shares in N Ltd. A/c To Loan — N Ltd. A/c (Being the shares in MN Ltd. received against investments in N Ltd. and loan to N Ltd. of ₹ 6,000 and ₹ 8,000 respectively)		14,000 14,000	20,000 8,000

Share Capital A/c Dr.		40,000	
Profit and Loss A/c Dr.		5,000	
To Sundry Shareholders (H Ltd.) A/c			45,000
(Being the share capital and Profit & Loss Account transferred to Sundry Shareholders Account)			
Sundry Shareholders (H Ltd.) A/c Dr.		26,000	
To Realisation A/c			26,000
(Being the loss on realisation transferred to Sundry Shareholders Account)			
Sundry Shareholders (H Ltd.) A/c Dr.		19,000	
Loan — H Ltd. A/c Dr.		10,000	
To Shares in MN Ltd. A/c			29,000
(Being the distribution of the shares received from MN Ltd. and liquidator of N Ltd.)			

Working Notes :

(1) Purchase consideration of M Ltd. = Sundry Assets – Creditors = ₹ 30,000 – ₹ 15,000 = ₹ 15,000.

(2) Loss on realisation of investment in shares of N Ltd. ₹ 14,000 can be transferred to Sundry Shareholders Account without transferring to Realisation Account. In that case, realisation loss will be ₹ 12,000 only.

Dr. (3) Realisation Account Cr.

Particulars	₹	Particulars	₹
To Sundry Assets A/c	42,000	By Creditors A/c	15,000
To Shares in N Ltd. A/c	14,000	By MN Ltd. A/c (Purchase Consideration)	15,000
(Loss on investment ₹ 20,000 – ₹ 6,000)		By Shareholders A/c (Loss on realisation)	26,000
	56,000		56,000

Dr. (4) Sundry Shareholders Account Cr.

Particulars	₹	Particulars	₹
To Realisation A/c	26,000	By Share Capital A/c	40,000
To Shares in MN Ltd. A/c	19,000	By Profit and Loss A/c	5,000
	45,000		45,000

Dr. (5) Shares in MN Ltd. Account Cr.

Particulars	₹	Particulars	₹
To MN Ltd. A/c (Purchase Consideration)	15,000	By Shareholders A/c	19,000
To Shares in N Ltd. A/c	6,000	By Loan — H Ltd. A/c	10,000
To Loan — N Ltd. A/c	8,000		
	29,000		29,000

Dr. (6) Shares in N Ltd. Account Cr.

Particulars	₹	Particulars	₹
To Balance b/d	20,000	By Shares in MN Ltd. A/c	6,000
		By Realisation A/c (Loss)	14,000
	20,000		20,000

Dr. (7) Loan — N Ltd. Account Cr.

Particulars	₹	Particulars	₹
To Balance b/d	8,000	By Shares in MN Ltd. A/c	8,000
	8,000		8,000

Dr. (8) Loan — H Ltd. Account Cr.

Particulars	₹	Particulars	₹
To Shares in MN Ltd. A/c	10,000	By Balance b/d	10,000
	10,000		10,000

Situation 2 : Transferee company holding shares of transferor company

The transferee company may hold some shares of the transferor company. At the time of liquidation of the transferor company, the transferee company will get a portion of the networth of transferor company as a shareholder of that company.

Generally, purchase consideration is satisfied by the issue of shares of the transferee company. But the transferee company cannot be paid in its own shares. In this case, only shares to be given to the outside shareholders will be issued by the transferee company to the liquidator of the transferor company.

Accounting adjustments are done in the following manner :

In the books of the Transferor Company

1. Transferee Company Account Dr. [Full purchase consideration]
   To Realisation Account

2. Shares in Transferee Company Account Dr. [Amount payable to outside shareholders]
   To Transferee Company Account

3. Sundry Shareholders Account Dr. [Amount payable to outside shareholders]
   To Shares in Transferee Company Account

After passing the above entries whatever balance is due from the transferee company is the exact amount payable to the transferee company as the remaining shareholders by the liquidators of the transferor company.

Now, the amount is neither given by the transferee company as a purchase consideration to the liquidator of the transferor company nor the liquidator of the transferor company will pay the transferee company as a shareholder. However, the following adjustment entry is to be passed :

Sundry Shareholders Account Dr. [Balance amount]
To Transferee Company Account

In the books of the Transferee Company

(a) In case of Amalgamation in the Nature of Merger

(i) Business Purchases Account Dr. [Net amount payable to outside shareholders]
To Liquidator of Transferor Company Account

(ii) Sundry Assets Account Dr.
To Sundry Liabilities Account
To Reserve Account [Adjusted]
To Profit and Loss Account
To Business Purchases Account [Net amount payable to outside shareholders]

(iii) Liquidator of Transferor Company Account Dr.
To Equity Share Capital Account [Net shares issued to outside shareholders]

(iv) Reserve Account Dr. [Cost of investment]
To Investment in Shares of Transferor Company Account

Illustration 25

The following are the Balance Sheets of A Ltd and B Ltd as on 1.4.2016 :

Balance Sheets of A Ltd. and B Ltd. as at 1st April, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 10 each		2,00,000	1,20,000
(b) Reserves and Surplus :			
Reserve		40,000	30,000
Profit and Loss Account		10,000	5,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Other Current Liabilities		10,000	15,000
TOTAL		2,60,000	1,70,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		1,40,000	1,00,000
(b) Non-current investments – 2,000 Shares in B Ltd.		24,000	—
(2) Current Assets :			
(a) Other Current Assets		96,000	70,000
TOTAL		2,60,000	1,70,000

B Ltd is absorbed by A Ltd by taking over all the assets and liabilities at book value. Purchase consideration being 4 equity shares of A Ltd of ₹ 10 each for every 5 shares held in B Ltd.

Show the necessary Ledger Accounts to close the books of B Ltd. Also show the journal entries and Balance Sheet of A Ltd after absorption.

Solution

Purchase consideration = 12,000 × 4/5 × ₹ 10 = ₹ 96,000. A Ltd holds 2,000 shares of B Ltd (out of total 12,000 shares). On liquidation of B Ltd., A Ltd will get 1/6th of the amount given to B Ltd., i.e., 1/6th of ₹ 96,000 = ₹ 16,000. At the time of payment of purchase consideration by A Ltd., it will pay after deducting ₹ 16,000. A Ltd will issue shares for ₹ 80,000 (₹ 96,000 – ₹ 16,000), i.e., 8,000 shares of ₹ 10 each.

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Land and Building A/c	1,00,000	2016	By Other Current Liabilities A/c	15,000
Apr. 1	To Current A/c	70,000	Apr. 1	By A Ltd. A/c	96,000
			"	By Sundry Equity Shareholders A/c	59,000
		1,70,000			1,70,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To A Ltd. A/c (set off)	16,000	2016	By Equity Share Capital A/c	1,20,000
Apr. 1	To Realisation A/c	59,000	Apr. 1	By Reserve A/c	30,000
	To Shares in A Ltd. A/c	80,000	"	By Profit and Loss A/c	5,000
		1,55,000			1,55,000

Dr. **A Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	96,000	2016	By Shares in A Ltd. A/c	80,000
Apr. 1			Apr. 1	By Sundry Equity Shareholders A/c (set off)	16,000
		96,000			96,000

Dr. **Shares in A Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To A Ltd. A/c	80,000	2016	By Sundry Equity Shareholders A/c	80,000
Apr. 1			Apr. 1		

In the books of A Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Business Purchase A/c	Dr.		80,000	
Apr. 1	To Liquidator of B Ltd. A/c				80,000
	(Being the amount payable to the liquidator of B Ltd. as per agreement dated . . .)				
	Land and Building A/c	Dr.		1,00,000	
	Other Current Assets A/c	Dr.		70,000	
	To Reserve A/c [₹ 30,000 – (80,000 – 1,20,000)]				70,000
	To Profit and Loss A/c				5,000

	To Other Current Liabilities A/c			15,000
	To Business Purchase A/c			80,000
	(Being the different assets and liabilities takenover and the difference between the share capital issued and share capital of B Ltd. adjusted against reserves)			
	Reserve A/c Dr.		24,000	
	To Investment A/c			24,000
	(Being the cost of investment in the shares of B Ltd. adjusted against the reserve)			
	Liquidator of B Ltd. A/c Dr.		80,000	
	To Equity Share Capital A/c			80,000
	(Being the issue of necessary shares to outside shareholders)			

It is an Amalgamation in the Nature of Merger because all assets and liabilities are taken over at book value and entire purchase consideration will be satisfied by issue of equity shares of A Ltd. Therefore, pooling of interests method of accounting for amalgamation has to be adopted.

A Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,80,000
(b) Reserves and Surplus	(2)	1,01,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Other Current Liabilities	(3)	25,000
TOTAL		4,06,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,40,000
(2) Current Assets :		
(a) Other Current Assets	(5)	1,66,000
TOTAL		4,06,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
28,000 Equity Shares of ₹ 10 each fully paid	2,80,000
(Of the above shares 8,000 equity shares have been issued for consideration other than cash)	

(2) Reserve and Surplus

Reserve	86,000
Profit and Loss Account	15,000
	1,01,000

(3) Other Current Liabilities

Particulars	₹
Other Current Liabilities (₹ 10,000 + ₹ 15,000)	25,000

(4) Fixed Assets

Tangible Assets :	
Building	2,40,000

(5) Other Current Assets

Other Current Assets (₹ 96,000 + 70,000)	1,66,000

Illustration 26

The following are the Balance Sheets of Yes Ltd. and No Ltd. as on 31st March, 2016 : (all figures in ₹ crores)

Particulars	Yes Ltd.		No Ltd.	
Sources of funds :				
Share Capital :				
Authorised		25		5
Issued and Subscribed : Equity Shares of ₹ 10 each fully paid		12		5
Reserve and Surplus		88		10
		100		15
Shareholders Funds				
Unsecured Fund from Yes Ltd.		—		10
		100		25
Funds employed in :				
Fixed Assets : Cost		70		30
Less: Depreciation		50		24
Written down value		20		6
Investments at cost : 30 Lakhs Equity Shares of ₹ 10 each of No Ltd.		3		
Long-term loan to No Ltd.		10		—
Current Assets	100		34	
Less: Current Liabilities	33	67	15	19
		100		25

On that day, Yes Ltd. absorbed No Ltd. The members of No Ltd. are to get one equity share of Yes Ltd. issued at a premium of ₹ 2 per share for every five equity shares held by them in No Ltd. The necessary approvals are obtained.

You are asked to pass journal entries in the books of the two companies to give effect to the above.

[C.A. (Inter) — Adapted]

Solution

Purchase consideration = 5,00,00,000 / 5 x 1 x ₹ 12 = ₹ 1,20,00,000. Yes Ltd. had 30 lakhs equity shares of No Ltd. (out of total 50 lakhs equity shares). On liquidation of No Ltd., Yes Ltd. will get 3/5th of ₹ 1,20,00,000 = ₹ 72,00,000. At the time of payment of purchase consideration by Yes Ltd., it will pay after deducting ₹ 72,00,000. Yes Ltd. will issue shares for ₹ 48,00,000 (₹ 1,20,00,000 – ₹ 72,00,000), i.e., ₹ 48,00,000 / 12 = 4,00,000 shares of ₹ 10 each at premium of ₹ 2 per share.

In the books of No Ltd.

Journal **Dr.** **Cr.**

Date	Particulars		L.F.	₹ (Crore)	₹ (Crore)
2016	Realisation A/c	Dr.		64.00	
Mar. 31	To Fixed Assets A/c				30.00
	To Current Assets A/c				34.00
	(Being different assets transferred to Realisation Account as per the scheme of amalgamation)				
	Unsecured Loans from Yes Ltd. A/c	Dr.		10.00	
	Current Liabilities A/c	Dr.		15.00	
	Provision for Depreciation A/c	Dr.		24.00	
	To Realisation A/c				49.00
	(Being different liabilities and provisions transferred to Realisation Account as per the scheme of amalgamation)				
	Yes Ltd. A/c	Dr.		1.20	
	To Realisation A/c				1.20
	(Being the amount due from Yes Ltd. in respect of purchase consideration)				
	Equity Share Capital A/c	Dr.		5.00	
	Reserve and Surplus A/c	Dr.		10.00	
	To Sundry Equity Shareholders A/c				15.00
	(Being the transfer of equity share capital and reserve and surplus to Sundry Equity Shareholders Account)				

	Particulars		L.F.	Dr.	Cr.
	Sundry Equity Shareholders A/c	Dr.		13.80	
	To Realisation A/c (Note 1)				13.80
	(Being the loss on realisation transferred to Sundry Equity Shareholders Account)				
	Equity Shares in Yes Ltd. A/c	Dr.		0.48	
	To Yes Ltd. A/c				0.48
	(Being 4,00,000 equity shares of ₹ 10 each fully issued at a premium of ₹ 2 per share received from Yes Ltd.)				
	Sundry Equity Shareholders A/c	Dr.		0.48	
	To Equity Shares in Yes Ltd. A/c				0.48
	(Being the shares of Yes Ltd. distributed amongst the outside shareholders)				
	Sundry Equity Shareholders A/c	Dr.		0.72	
	To Yes Ltd. A/c				0.72
	(Being the set-off for 30 lakhs shares held by Yes Ltd. in No Ltd.)				

Working Note :

Dr. **(1) Realisation Account** **Cr.**

Date	Particulars	₹ (Crore)	Date	Particulars	₹ (Crore)
2016	To Fixed Assets A/c	30.00	2016	By Unsecured Loan from Yes Ltd. A/c	10.00
Mar 31	To current Assets A/c	34.00	Mar 31	By Current Liabilities A/c	15.00
				By Provision for Depreciation A/c	24.00
				By Yes Ltd. A/c (purchase consideration)	1.20
				By Sundry Equity Shareholders A/c	13.80
		64.00			64.00

It is an Amalgamation in the Nature of Merger because all assets and liabilities are taken over at book value and entire purchase consideration will be satisfied by issue of equity shares of A Ltd. Therefore, pooling of interests method of accounting for amalgamation has to be adopted.

In the books of Yes Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Fixed Assets A/c	Dr.		30.00	
Mar. 31	Current Assets A/c	Dr.		34.00	
	To Unsecured Loan from Yes Ltd. A/c				10.00
	To Current Liabilities A/c				15.00
	To Provision for Depreciation A/c				24.00
	To Business Purchase A/c				0.48
	To Reserve and Surplus [10 – (0.48 – 5)]				14.52
	(Being the different assets and liabilities taken over. The difference between the share capital issued including premium and share capital of No Ltd. adjusted in reserve and surplus)				
	Business Purchase A/c	Dr.		0.48	
	To Liquidator of No Ltd. A/c				0.48
	(Being the amount payable to the liquidator of No Ltd. as per agreement dated . . .)				
	Liquidator of No Ltd. A/c	Dr.		0.48	
	To Equity Share Capital A/c				0.40
	To Securities Premium A/c				0.08
	(Being the issue of 4,00,000 equity shares of ₹ 10 each fully paid up at a premium of ₹ 2 per share to satisfy the purchase consideration)				
	Reserve and Surplus A/c	Dr.		3.00	
	To Investment in Shares of No Ltd. A/c				3.00
	(Being the cost of investment in shares of No Ltd. adjusted against reserve and surplus)				
	Unsecured Loan from Yes Ltd. A/c	Dr.		10.00	
	To Long-term Loan to No Ltd. A/c				10.00
	(Being the set-off of loan to No Ltd.)				

(b) In case of Amalgamation in the Nature of Purchase

(i) Business Purchase Account	Dr.	[Total purchase consideration]
To Liquidator of Transferor Company Account		
(ii) Sundry Assets Account	Dr.	[Individually, at agreed value]
To Sundry Liabilities Account		[Individually, at agreed value]
To Business Purchases Account		[Total purchase consideration]
To Capital Reserve Account		[Balancing figure]
Or		
Sundry Assets Account	Dr.	[Individually, at agreed value]
Goodwill Account	Dr.	[Balancing figure]
To Sundry Liabilities Account		[Individually, at agreed value]
To Business Purchases Account		[Total Purchase Consideration]
(iii) Liquidator of Transferor Company Account	Dr.	
To Equity Share Capital Account		[Net shares issued]
(iv) Liquidator of Transferor Account	Dr.	[Difference between total purchase consideration – Share capital issued]
To Investment in Shares of Transferor Company Account		

Balance of Investment in Shares of Transferor Company Account will be closed by transferring to Goodwill Account or Capital Reserve Account.

Alternative Entries

(i) Business Purchase Account	Dr.	[Net amount payable to outside shareholders]
To Liquidator of Transferor Company Account		
(ii) Sundry Assets Accounts	Dr.	[Individually, at agreed value]
To Sundry Liabilities Account		[Individually, at agreed value]
To Business Purchases Account		[Net purchase consideration]
To Capital Reserve Account		[Balancing figure]
Or		
Sundry Assets Account	Dr.	[Individually, at agreed value]
Goodwill Account	Dr.	[Balancing figure]
To Sundry Liabilities Account		[Individually, at agreed value]
To Business Purchases Account		[Net amount payable to outside shareholders]
(iii) Liquidator of Transferor Company Account	Dr.	
To Equity Share Capital Account		[Net shares issued]
(iv) Goodwill / Capital Reserve Account	Dr.	[Cost of investment]
To Investment in Shares of Transferor Company Account		

Illustration 27

The Balance Sheets of Sun Ltd. and Moon Ltd. as on 31.03.2016 are as below :

Balance Sheets of Sun. Ltd. and Moon Ltd. as at 31st March, 2016

Particulars	Note No.	Sun Ltd. (₹)	Moon Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		5,00,000	4,00,000
8% Preference Share of ₹ 100 each		5,00,000	1,00,000
(b) Reserves and Surplus — Reserve		1,40,000	1,00,000
(2) Share Application Money Pending Allotment :		—	—

(3) Non-current Liabilities :			
(a) Long-term Borrowings — 7% Debentures of ₹ 100 each		—	1,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings — Loan from Sun Ltd.		—	30,000
(b) Other Current Liabilitiess		2,50,000	70,000
TOTAL		13,90,000	8,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Land and Building		8,00,000	6,00,000
(b) Non-current investments — 5,000 Equity Shares of Moon Ltd.		60,000	—
(2) Current Assets :			
(a) Short-term Loans and Advances — Loan to Moon Ltd.		30,000	—
(b) Other Current Assets		5,00,000	2,00,000
TOTAL		13,90,000	8,00,000

Sun Ltd. decides to take over Moon Ltd. on the following terms :

(a) Sun Ltd. will issue 7 equity shares of ₹ 10 at a premium of 20% and ₹ 5 cash for 5 equity shares of Moon Ltd. surrendered.

(b) Preference shareholders of Moon Ltd. are to be given one 6% preference share of ₹ 100 in Sun Ltd. for every share held. These shares are to be issued at a premium of 5%.

(c) 7% Debentures of Moon Ltd. are to be redeemed at 8% premium by issue of 7% Debentures of Sun Ltd. at 10% discount.

(d) Liquidation expenses amounting to ₹ 10,000 are to be paid by Sun Ltd.

(e) Sun Ltd. revalues the fixed assets of Moon Ltd. at ₹ 8,00,000 on take over.

Close the books of Moon Ltd., pass journal entries in the books of Sun Ltd. and prepare the Balance Sheet after the takeover.

Solution **Calculation of Purchase Consideration**

Particulars	₹	₹
(i) Preference Shareholders :		1,05,000
6% Preference Shares in Sun Ltd. (1,000 x ₹ 105)		
(ii) Equity Shareholders :		
(a) Equity Shares [40,000 / 5 x 7 x ₹ 12]	6,72,000	
(b) Cash [40,000 / 5 x ₹ 5]	40,000	7,12,000
Total Purchase Consideration		8,17,000
Purchase Consideration will be paid by Sun Ltd.		
(i) In 6% Preference Shares of Sun Ltd.		1,05,000
(ii) In Equity Shares (7/8 of ₹ 6,72,000)		5,88,000
(iii) In Cash (7/8 of ₹ 40,000)		35,000
		7,28,000

In the books of Moon Ltd.

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016 Mar. 31	To Land and Building A/c	6,00,000	2016 Mar. 31	By 7% Debentures A/c	1,00,000
"	To Current Assets A/c	2,00,000	"	By Loan from Sun Ltd. A/c	30,000
"	To Sundry Preference Shareholders A/c	5,000	"	By Other Liabilities A/c	70,000
"	To Sundry Equity Shareholders A/c (Profit)	2,12,000	"	By Sun Ltd. A/c (purchase consideration)	8,17,000
		10,17,000			10,17,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Equity Shares in Sun Ltd. A/c	5,88,000	2016	By Equity Share Capital A/c	4,00,000
Mar. 31	To Bank A/c	35,000	Mar. 31	By Reserves A/c	1,00,000
"	To Sun Ltd. A/c (set-off)	89,000	"	By Realisation A/c (Profit)	2,12,000
		7,12,000			7,12,000

Dr. **Sun Ltd. Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Realisation A/c	8,17,000	2016	By 6% Preference Shares in Sun Ltd.	1,05,000
Mar. 31			Mar. 31	By Equity Shares in Sun Ltd. A/c	5,88,000
			"	By Bank A/c	35,000
			"	By Sundry Equity Shareholders A/c (set-off)	89,000
		8,17,000			8,17,000

Dr. **Sundry Preference Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To 6% Preference Shares in Sun Ltd. A/c	1,05,000	2016	By 7% Preference Share Capital A/c	1,00,000
Mar. 31			Mar. 31	By Realisation A/c (Extra amount paid)	5,000
		1,05,000			1,05,000

In the books of Sun Ltd.

Journal **Dr.** **Cr.**

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Business Purchase A/c	Dr.		8,17,000	
Mar. 31	To Liquidator of Moon Ltd. A/c				8,17,000
	(Being the amount payable to the liquidator of Moon Ltd. as per agreement)				
	Land and Building A/c	Dr.		8,00,000	
	Current Assets A/c	Dr.		2,00,000	
	Goodwill A/c (Balancing figure)	Dr.		17,000	
	To 7% Debentures in Sun Ltd. A/c				1,00,000
	To Loan from Sun Ltd. A/c				30,000
	To Other Liabilities A/c				70,000
	To Business Purchase A/c				8,17,000
	(Being different assets and liabilities taken over. The difference between the net assets taken over and purchase consideration paid transferred to Goodwill Account)				
	Liquidator of Moon Ltd. A/c	Dr.		7,28,000	
	To Equity Share Capital A/c				4,90,000
	To 6% Preference Share Capital A/c				1,00,000
	To Securities Premium A/c (₹ 98,000 + 5,000)				1,03,000
	To Bank A/c				35,000
	(Being the issue of 49,000 equity shares of ₹ 10 each at a premium of 20% and issue of 1,000, 6% preference shares of ₹ 100 each at a premium of 5% and payment of cash to the liquidator of Moon Ltd. to satisfy the purchase consideration)				
	Goodwill A/c	Dr.		10,000	
	To Bank A/c				10,000
	(Being the liquidation expenses of Moon Ltd. paid)				
	Liquidator of Moon Ltd. A/c	Dr.		89,000	
	To Investment A/c (Shares in Moon Ltd.)				60,000
	To Goodwill A/c (₹ 17,000 + 10,000)				27,000
	To Capital Reserve A/c				2,000
	(Being the investment in the shares of Moon Ltd. set-off and the difference between the book value of investment and set-off value adjusted against goodwill)				

7% Debentures in Moon Ltd. A/c	Dr.	1,00,000	
Premium on Redemption of Debentures A/c	Dr.	8,000	
To Debentureholders of Moon Ltd. A/c			1,08,000
(Being the amount payable to debentureholders of Moon Ltd.)			
Debentureholders of Moon Ltd. A/c	Dr.	1,08,000	
Discount on Issue of Debentures A/c	Dr.	12,000	
To 7% Debentures A/c			1,20,000
(Being the issue of 1,200, 7% debentures of ₹ 100 each at a discount of 10%)			
Securities Premium A/c (Note 1)	Dr.	20,000	
To Premium on Redemption of Debentures A/c			8,000
To Discount on Issue of Debentures A/c			12,000
(Being the adjustment of premium paid on redemption of debentures and discount on issue of debentures against Securities Premium Account)			
Loan from Sun Ltd. A/c	Dr.	30,000	
To Loan to Moon Ltd. A/c			30,000
(Being adjustment for mutual indebtedness)			

Working Note : (1) Premium on redemption of debentures and discount on issue of debentures have been adjusted against Securities Premium Account as per the Provision of Section 52 of the Companies Act, 2013.

Sun Ltd
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	15,90,000
(b) Reserves and Surplus	(2)	2,25,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	1,20,000
(4) Current Liabilities :		
(a) Trade Payables	(4)	3,20,000
TOTAL		22,55,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	16,00,000
(2) Current Assets :		
(a) Other Current Assets	(6)	6,55,000
TOTAL		22,55,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
99,000 Equity Shares of ₹ 100 each fully paid	9,90,000
6,000, 6% Preference Shares of ₹ 100 each	6,00,000
(Of the above shares 49,000 equity shares and 1,000 preference shares have been issued for consideration other than cash)	
	15,90,000

(3) Long-term Borrowings

Particulars	₹
Secured :	
7% Debentures	1,20,000
(4) Other Current Liabilities	3,20,000
(5) Fixed Assets	
Tangible Assets :	
Land and Building	16,00,000
(6) Other Current Assets	6,55,000

(2) Reserve and Surplus			
Capital Reserve	2,000		
Securities Premium (₹ 1,03,000 – 20,000)	83,000		
Investment Allowance Reserve	1,40,000		
	2,25,000		

Illustration 28

The following is the summarised Balance Sheet of A Ltd. as on 31.3.2016 :

Balance Sheet of A Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 20,000 Equity Shares of ₹ 10 each		2,00,000
(b) Reserves and Surplus — Reserve		5,00,000
Profit and Loss Account		80,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) External Liabilities		12,00,000
TOTAL		19,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		19,80,000
(2) Current Assets :		
TOTAL		19,80,000

At 31.3.2015, assets of B Ltd. amount to ₹ 40,00,000 (including 3,000 equity shares issued by A Ltd. at a premium of 150%) and external liabilities aggregate to ₹ 15,00,000 and general reserve ₹ 5,00,000.

On 1.4.2016, B Ltd. absorbs A Ltd. For the purpose of absorption the value of each share of A Ltd. will be ₹ 39 each.

Pass the necessary journal entries in the books of B Ltd. and show the summarised post-acquisition Balance Sheet. Assume that B Ltd. immediately settles A Ltd.'s account by issuing 15% debentures.

Solution

In this problem, the Balance Sheet of B Ltd. before absorption is not given. Therefore, it is necessary to prepare the Balance Sheet from the given information.

Balance Sheet of B Ltd.

Liabilities	₹	Assets	₹
Share Capital (Balancing figure)	20,00,000	Sundry Assets (₹ 40,00,000 – ₹ 75,000)	39,25,000
General Reserve	5,00,000	Investments — Shares in A Ltd. [3,000 x ₹ (10 – ₹ 15)]	75,000
External Liabilities	15,00,000		
	40,00,000		40,00,000

Calculation of Purchase Consideration

Total purchase consideration = 20,000 x ₹ 39 = ₹ 7,80,000. B Ltd. holds 3,000 shares of A Ltd. (out of 20,000 shares). On liquidation of A Ltd., the amount of purchase consideration payable to outside shareholders = ₹ 7,80,000 x 17,000 / 20,000 = ₹ 6,63,000.

It is an ***Amalgamation in the Nature of Purchase*** because the purchase consideration will not be satisfied by issue of shares but by issue of 15% debentures. Therefore, purchase method of accounting for amalgamation has to be adopted.

In the books of B Ltd.
Journal — Dr. / Cr.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 April 1	Business Purchase A/c	Dr.		7,80,000	
	To Liquidator of A Ltd. A/c				7,80,000
	(Being the amount payable to the liquidator of A Ltd. as per agreement dated . . .)				
	Sundry Assets A/c	Dr.		19,80,000	
	To External Liabilities A/c				12,00,000
	To Business Purchase. A/c				7,80,000
	(Being different assets taken over from A Ltd.)				
	Liquidator of A Ltd. A/c (₹ 7,80,000 – 6,63,000)	Dr.		1,17,000	
	To Investments A/c				75,000
	To Capital Reserve A/c				42,000
	(Being the shares in A Ltd. surrendered to the liquidator of A Ltd. — the difference is transferred to Capital Reserve)				
	Liquidator of A Ltd.A/c	Dr.		6,630400	
	To 15% Debentures A/c				6,63,000
	(Being the issue of debentures to the liquidator of A Ltd. for payment to outside shareholders)				

B Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	20,00,000
(b) Reserves and Surplus	(2)	5,42,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	6,63,000
(4) Current Liabilities :		
(a) Other Current Liabilities — External Liabilities	(4)	27,00,000
TOTAL		59,05,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		—
(i) Tangible Assets	(5)	59,05,000
(2) Current Assets :		
TOTAL		59,05,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
2,00,000 Equity Shares of ₹ 10 each fully paid	20,00,000

(3) Long-Term Borrowings

Particulars	₹
Secured :	
15% Debentures	6,63,000

(4) Other Current Liabilities

Particulars	₹
External Liabilities	27,00,000

(2) Reserve and Surplus		**(5) Fixed Assets**	
Capital Reserve	42,000	*Tangible Assets :*	
General Reserve	5,00,000	Sundry Assets (₹ 39,25,000 + 19,80,000)	59,05,000
	5,42,000		

Illustration 29

X Ltd. had acquired, as a current asset, 9,000 shares in Y Ltd., for ₹ 90,000 on 1st November, 2010. On 1st April, 2016 it agreed to absorb Y Ltd., the consideration being —

(i) The assumption of its liabilities.

(ii) The discharge of ₹ 60,000 debentures held outside the company at a premium of 10% by the issue of 15% debentures in X Ltd. carrying a full six months' interest payable on 1st October, 2016.

(iii) A payment in cash of ₹ 5 per share in Y Ltd.

(iv) The issue of shares of ₹ 10 each in X Ltd., credited as fully paid; to the members of Y Ltd., on the basis of two equity shares (valued at ₹ 16 each) and one 15% redeemable preference share (valued at ₹ 11 each) for five shares held in Y Ltd.

The summarised Balance Sheet of Y Ltd. as on 31st March, 2016 was as follows :

Balance Sheet of Y Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 24,000 Equity Shares of ₹ 10 each, ₹ 7.50 per share paid		1,80,000
(b) Reserves and Surplus :		1,12,500
General Reserve		45,000
Profit and Loss Account		25,000
Insurance Fund (See Note)		
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		67,500
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors		20,000
TOTAL		4,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land		1,05,000
Building		50,000
Plant		60,000
(ii) Intangible assets — Goodwill		28,000
(b) Non-current investments :		
Insurance Fund		25,000
Genera—12% Debentures in Y Ltd.l (₹ 7,500)		7,000
(2) Current Assets :		
(a) Inventories		1,00,000
(b) Trade Receivables — Debtors		50,000
(c) Cash and Cash Equivalents — Cash at Bank		25,000
TOTAL		4,50,000

Note : The company had been carrying its own insurance risk crediting amount equivalent to premium to the Fund and charging losses thereto.

It was agreed that for absorption purposes, 5% should be written off stock and 5% provision for doubtful debts. The remaining assets, other than goodwill, are considered to be properly valued for the purpose of absorption.

The absorption was completed on 1st June, 2016 by the issue of necessary shares and debentures in X Ltd. and payment of cash. Y Ltd. was thereon wound up and distribution of its assets made to its members. Expenses ₹ 2,000 in this connection paid by X Ltd.

You are required to draft the journal entries (including cash items) in the books of Y Ltd. and in the books of X Ltd.

Solution **Calculation of Purchase Consideration**

Particulars	₹
Equity Shareholders :	
(a) Cash [24,000 x ₹ 5]	1,20,000
(b) Equity Shares [24,000 x 2/5 x ₹ 16]	1,53,600
(c) Preference Shares [24,000 x 1/5 x ₹ 11]	52,800
Total Purchase Consideration	3,26,400
Purchase Consideration to be paid by X Ltd.	
(a) In cash [15/24 of ₹ 1,20,000]	75,000
(b) In Equity Shares [15/24 of ₹ 1,53,600]	96,000
(c) In 15% Redeemable Preference Shares [15/24 of ₹ 52,800]	33,000
	2,04,000

In the books of Y Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 April 1	Realisation A/c	Dr.		4,43,000	
	To Land A/c				1,05,000
	To Building A/c				50,000
	To Plant A/c				60,000
	To Inventories A/c				1,00,000
	To Debtors A/c				50,000
	To Bank A/c				25,000
	To Investments A/c (Insurance Fund)				25,000
	To Goodwill A/c				28,000
	(Being different assets transferred to Realisation Account as per scheme of absorption)				
	12% Debentures A/c (₹ 67,500 – 7,500)	Dr.		60,000	
	Creditors A/c	Dr.		20,000	
	To Realisation A/c				80,000
	(Being different liabilities transferred to Realisation Account as per scheme of reconstruction)				
	X Ltd. A/c	Dr.		3,26,400	
	To Realisation A/c				3,26,400
	(Being the purchase consideration due from X Ltd. as per agreement)				
	12% Debentures A/c	Dr.		7,500	
	To Investment in Own Debentures A/c				7,000
	To Realisation A/c				500
	(Being the cancellation of own debentures. The profit on cancellation transferred to Realisation Account)				
	Equity Shares in X Ltd. A/c	Dr.		96,000	
	15% Redeemable Preference Shares in X Ltd. A/c	Dr.		33,000	
	Cash A/c	Dr.		75,000	
	To X Ltd. A/c				2,04,000
	(Being the purchase consideration received from X Ltd. in the form of 6,000 equity shares of ₹ 10 each fully paid issued at a premium of ₹ 6 per share and 3,000, 15% redeemable preference shares of ₹ 10 each fully paid issued at a premium of Re 1 per share and cash ₹ 75,000)				
	Share Capital A/c	Dr.		1,80,000	
	General Reserve A/c	Dr.		1,12,500	

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Profit and Loss A/c	Dr.		45,000	
	Insurance Fund A/c	Dr.		25,000	
	To Sundry Shareholders A/c				3,62,500
	(Being the amount transferred to Sundry Shareholders Account)				
	Sundry Shareholders A/c	Dr.		36,100	
	To Realisation A/c (Note 1)				36,100
	(Being the loss on realisation transferred to Sundry Shareholders Account)				
	Sundry Shareholders A/c	Dr.		2,04,000	
	To Equity Shares in X Ltd. A/c				96,000
	To 15% Redeemable Preference Shares in X Ltd. A/c				33,000
	To Cash A/c				75,000
	(Being the distribution of shares and cash amongst the outside shareholders)				
	Sundry Shareholders A/c	Dr.		1,22,400	
	To X Ltd. A/c				1,22,400
	(Being the set-off for 9,000 shares held by X Ltd. in Y Ltd.)				

Working Note :

Dr. **(1) Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Land A/c	1,05,000		By 12% Debentures A/c	60,000
	To Building A/c	50,000		By Creditors A/c	20,000
	To Plant A/c	60,000		By X Ltd. A/c	3,26,400
	To Inventories A/c	1,00,000		By 12% Debentures A/c	500
	To Debtors A/c	50,000		By Sundry Shareholders A/c	36,100
	To Bank A/c	25,000			
	To Investments A/c (Insurance Fund)	25,000			
	To Goodwill Ac	28,000			
		4,43,000			4,43,000

It is an Amalgamation in the Nature of Purchase because all assets and liabilities will not be taken over at book value and purchase consideration will not be satisfied totally by issue of shares. Therefore, purchase method of accounting for amalgamation is to be adopted.

In the books of X Ltd.

Journal **Dr.** **Cr.**

Date	Particulars		L.F.	₹	₹
2016 April 1	Business Purchase A/c	Dr.		3,26,400	
	To Liquidator of Y Ltd. A/c				3,26,400
	(Being the amount payable to the liquidator of Y Ltd. as per agreement dated . . .)				
	Land A/c	Dr.		1,05,000	
	Building A/c	Dr.		50,000	
	Plant A/c	Dr.		60,000	
	Inventories A/c	Dr.		95,000	
	Debtors A/c	Dr.		50,000	
	Investment A/c (Insurance Fund)	Dr.		25,000	
	Goodwill A/c (Balancing figure)	Dr.		23,900	
	To 12% Debentures in Y Ltd. A/c				60,000
	To Creditors A/c				20,000
	To Provision for Bad Debts A/c				2,500
	To Business Purchase A/c				3,26,400
	(Being different assets and liabilities taken over at agreed value as per the scheme of amalgamation. The different between the net assets taken over and purchase consideration paid transferred to Goodwill Account)				
	Goodwill A/c	Dr.		2,000	
	To Bank A/c				2,000
	(Being liquidation expenses paid)				

June 1	12% Debentures in Y Ltd. A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debentureholders A/c (Being the amount payable to debentureholders of Y Ltd.)	60,000 6,000	 66,000
	Debentureholders A/c Dr. To 15% Debentures A/c (Being the issue of necessary debentures in X Ltd.)	66,000	 66,000
	Liquidator of Y Ltd. A/c Dr. To Equity Share Capital A/c To 15% Redeemable Preference Capital A/c To Securities Premium A/c (₹ 36,000 + 3,000) To Cash A/c (Being the issue of 6,000 equity shares of ₹ 10 each fully paid at a premium of ₹ 6 per share and issue of 3,000, 15% redeemable preference shares of ₹ 10 each fully paid at a premium of ₹ 1 each and balance paid in cash)	2,04,000	 60,000 30,000 39,000 75,000
	Securities Premium A/c Dr. To Premium on Redemption of Debentures A/c (Being the premium on redemption of debentures adjusted against the Securities Premium Account)	6,000	 6,000
	Liquidator of Y Ltd. A/c Dr. To Investment in Y Ltd. A/c To Goodwill A/c To Capital Reserve A/c (Being the investment in the shares of Y Ltd. set-off and the difference between the book value of investment and set-off value adjusted against goodwill and capital reserve)	1,22,400	 90,000 25,900 6,500

Situation 3 : *Transferor Company holding some Shares of Transferee Company*

The transferor company may hold some shares of the transferee company. At the time of amalgamation, these shares cannot be taken over along with other assets by the transferee company. These shares will remain in the hands of the liquidator of the transferor company. When the transferee company will issue its own share against purchase consideration, the shares already held by the liquidator will be deducted from the total number of shares to be issued. New shares issued plus shares already in hand are distributed amongst shareholders. Debentures held by the transferor company in the transferee company are also similarly treated.

The cost of shares held by the transferor company by way of investment may be different from the valuations at which they are now being issued. In such a situation, the existing shares are to be adjusted by revaluation to same values at which they are issued at present.

The entry will be :

(i) If revalued at a higher price

Investment in Shares of Transferee Company Account Dr.
To Sundry Shareholders Account

(ii) If revalued at a lower price

Sundry Shareholders Account Dr.
To Investment in Shares of Transferee Company Account

Illustration 30

A Ltd. absorbs B Ltd. on 1st April, 2016 by payment of 6 shares of ₹ 10 each for every 5 shares of B Ltd. Their Balance Sheets as at 31st March, 2016, are as follows :

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		6,00,000	2,00,000
(b) Reserves and Surplus — Reserve		80,000	40,000

(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		6,00,000	60,000
TOTAL		7,40,000	3,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		6,00,000	2,00,000
(b) Non-current investments — 4,000 Equity Shares of A Ltd.		—	40,000
(2) Current Assets :			
(a) Other Current Assets		1,40,000	60,000
TOTAL		7,40,000	3,00,000

Show Ledger Accounts in the books of B Ltd. Pass journal entries in the books of A Ltd. and prepare the Balance Sheet after amalgamation. (Assume amalgamation in the nature of purchase.)

Solution **Calculation of Purchase Consideration**

Particulars	₹	₹
Number of shares required (20,000 / 5 x 6)		24,000
Less: Already in hand		4,000
New shares to be issued		20,000
20,000 shares @ ₹ 10 each = ₹ 2,00,000)		

In the books of B Ltd.

Dr. **Realisation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Plant and Machinery A/c	2,00,000	2016	By Sundry Creditors A/c	60,000
Apr. 1	To Current Assets A/c	60,000	Apr. 1	By A Ltd. A/c	2,00,000
		2,60,000			2,60,000

Dr. **Investment Account (Shares in A Ltd.)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Balance b/d : 4,000 shares	40,000	2016	By Sundry Equity Shareholders A/c	2,40,000
Apr. 1	To A Ltd. A/c : 20,000 shares	2,00,000	Apr. 1		
		2,40,000			2,40,000

Dr. **Sundry Equity Shareholders Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Investment A/c	2,40,000	2016	By Equity Share Capital A/c	2,00,000
Apr. 1			Apr. 1	By Reserve A/c	40,000
		2,40,000			2,40,000

As it is an Amalgamation in the Nature of Purchase, the purchase method of accounting for amalgamation is to be adopted.

In the books of A Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2016	Business Purchase A/c Dr.		2,00,000	
Apr. 1	To Liquidator of B Ltd. A/c			2,00,000
	(Being the amount payable to the liquidator of B Ltd. as per agreement dated . . .)			

Plant and Machinery A/c	Dr.		2,00,000	
Current Assets A/c	Dr.		60,000	
To Sundry Creditors A/c				60,000
To Business Purchase A/c				2,00,000
(Being the different assets and liabilities taken over)				
Liquidator of B Ltd. A/c	Dr.		2,00,000	
To Equity Share Capital A/c				2,00,000
(Being the issue of 20,000 shares to the liquidator of B Ltd. in satisfaction of purchase consideration)				

A Ltd
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus	(2)	80,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	1,20,000
TOTAL		10,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	8,00,000
(2) Current Assets :		
(a) Other Current Assets	(5)	2,00,000
TOTAL		10,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
80,000 Equity Shares of ₹ 10 each fully paid	8,00,000
(Of the above shares 20,000 equity shares have been issued for consideration other than cash)	

(2) Reserve and Surplus

Reserve	80,000

(3) Trade Payables

Particulars	₹
Sundry Creditors	1,20,000

(4) Fixed Assets

Tangible Assets :	
Plant and Machinery	8,00,000

(5) Other Current Assets

(5) Other Current Assets	2,00,000

Illustration 31

Sad Limited presents the following summarised Balance Sheet as on 31st March, 2016 :

Balance Sheet of Sad Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each		12,00,000
(b) Reserves and Surplus — Profit and Loss Account		(3,75,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		7,50,000
(4) Current Liabilities :		
(b) Trade Payables — Creditors		4,27,500
(c) Other Current Liabilities — Accrued Interest		37,500
TOTAL		20,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		12,75,000
(2) Current Assets :		
(a) Other Current Assets		7,65,000
TOTAL		20,40,000

The company is absorbed by Poor Ltd. who holds 25% of share capital (purchased by them for ₹ 2,00,000). All assets and liabilities are taken over at book value, subject to Fixed Assets revalued at ₹ 10,50,000.

The payments to other shareholders to be made by the issue of equity shares of ₹ 15 each at par of Poor Ltd. For the purpose of absorption each share of Sad Ltd. each worth ₹ 5.

Show the entries in the books of Sad Ltd. and acquisition entries in the books of Poor Ltd.

Solution

Purchase Consideration

	₹
Value of shares of Sad Ltd. = ₹ 12,00,000 / ₹ 10 x ₹ 5	6,00,000
Value of shares held by Poor Ltd. (1/4)	1,50,000
Values of shares held by outsiders	4,50,000
Number of shares to be issued by Poor Ltd. = ₹ 4,50,000 / ₹ 15 = 30,000 shares	

In the books of Sad Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Realisation A/c	Dr.		20,40,000	
Mar. 31	To Fixed Assets A/c				12,75,000
	To Current Assets A/c				7,65,000
	(Being the transfer of different assets to Realisation Account as per the scheme of amalgamation)				
	5% Debentures A/c	Dr.		7,50,000	
	Accrued Interest A/c	Dr.		37,500	
	Creditors A/c	Dr.		4,27,500	
	To Realisation A/c				12,15,000
	(Being the transfer of different liabilities to Realisation Account as per the scheme of amalgamation)				

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Poor Ltd. A/c Dr. To Realisation A/c (Being the purchase consideration due from Poor Ltd.)		6,00,000	6,00,000
	Share Capital A/c Dr. To Sundry Shareholders A/c (Being the transfer of share capital to Sundry Shareholders Account)		12,00,000	12,00,000
	Sundry Shareholders A/c Dr. To Profit and Loss A/c (Being the debit balance of Profit and Loss Account transferred to Sundry Shareholders Account)		3,75,000	3,75,000
	Sundry Shareholders A/c (Note 1) Dr. To Realisation A/c (Being the loss on realisation transferred to Sundry Shareholders Account)		2,25,000	2,25,000
	Shares in Poor Ltd. A/c Dr. To Poor Ltd. A/c (Being the receipt of 30,000 shares @ ₹ 15 each for payment to outside shareholders)		4,50,000	4,50,000
	Sundry Shareholders A/c Dr. To Shares in Poor Ltd. A/c (Being the payment of shares to the outside shareholders)		4,50,000	4,50,000
	Sundry Shareholders A/c Dr. To Poor Ltd. A/c (Being the adjustment of 25% shares held by Poor Ltd.)		1,50,000	1,50,000

In the books of Poor Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 Mar. 31	Business Purchase A/c Dr. To Liquidator of Sad Ltd. A/c (Being the amount payable to the liquidator of Sad Ltd. as per agreement dated . . .)		6,00,000	6,00,000
	Fixed Assets A/c Dr. Current Assets A/c Dr. To 5% Debentures A/c To Accrued Interest A/c To Creditors A/c To Business Purchase A/c (Being the different assets and liabilities taken over at agreed value)		10,50,000 7,65,000	7,50,000 37,500 4,27,500 6,00,000
	Liquidator of Sad Ltd. A/c Dr. To Equity Share Capital A/c (Being the issue of necessary shares to pay off the outside shareholders)		4,50,000	4,50,000
	Liquidator of Sad Ltd. A/c Dr. Goodwill A/c (Balancing figure) Dr. To Investment in Sad Ltd. A/c (Being the shares in Sad Ltd. surrendered to the liquidator of Sad Ltd. The difference is transferred to Goodwill Account)		1,50,000 50,000	2,00,000

Tutorial Note : It is an amalgamation in the nature of purchase because all assets are not taken over at book value. Therefore, purchase method of accounting for amalgamation is to be adopted.

Working Note :

Dr. (1) Realisation Account Cr.

Particulars	₹	Particulars	₹
To Fixed Assets A/c	12,75,000	By 5% Debentures A/c	7,50,000
To Current Assets A/c	7,65,000	By Accrued Interest A/c	37,500
		By Creditors A/c	4,27,500
		By Poor Ltd. A/c	6,00,000
		By Sundry Shareholders A/c	2,25,000
	20,40,000		20,40,000

KEY POINTS

- Amalgamation is an event or transaction in which two or more companies, or their net assets, are brought under common control in a single legal entity. The concept of control relates to the ability to dictate operating and financial policies.
- The main motives for amalgamations are :

(1) Economies of Scale — The amalgamated company can have operating cost advantage, in effect, lower average cost of production.
(2) Financial Economies — Financial economies can be in the form of tax-advantage, higher debt capacity and lower rates of borrowing, less flotation of shares and debentures, etc.
(3) Growth — Internal growth is time consuming. It can also prevent a competitor from establishing a similar position in that industry. In a saturated market, amalgamation makes more sense than creation of additional production capacity through internal expansion.

(4) Diversification — In an amalgamation, risk of the company can be lowered by diversifying into two or more industries. Diversification is a situation in which a company takes on new lines of business, to reduce the degree of risk.
(5) Managerial Effectiveness — Effectiveness is the degree of attainment of a predetermined goal. Management effectiveness can be availed of through superior management talent or a research capability.
The purchase consideration is determined as per the agreement between the companies. While calculating purchase consideration, the provision of AS—14, Para 3(g) must be taken into consideration. It defines the expression 'Purchase Consideration' as "the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company."

- There are two main methods of accounting for amalgamations : (a) The Pooling of Interests Method; and (b) The Purchase Method.
- **Characteristics of Pooling of Interests Method** :

1. Pooling of interests accounting treats an amalgamation as a '***non-event***', in that the combining companies are viewed as if they always had been together.
2. The unique attributes of pooling of interests accounting are the carryforward of assets and liabilities at book values and the carryforward of retained earnings.
3. Under pooling of interests accounting, ***no goodwill*** is recorded as arising from the amalgamation.
4. All costs associated with the amalgamation or with issuing the shares used in the amalgamation are expended as incurred; none of the costs of bringing about the amalgamation are ***capitalised***.
5. Under pooling of interests accounting, the carryforward of retained earnings of the acquired company may give management more flexibility with respect to dividends subsequent to the amalgamation.

THEORETICAL QUESTIONS

1. What do you mean by amalgamation ? What are the different types of amalgamation ?
2. What are the different conditions which must be satisfied for treating an amalgamation in the nature of merger ?
3. How purchase consideration is calculated according to AS—14 ?
4. Distinguish between pooling of interests method and purchase method.
5. What are the limitations of pooling of interests method ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Amalgamation Adjustment Account is used for recording
   A capital reserve in the books of the transferee company
   B general reserve in the books of the transferee company
   C statutory reserve in the books of the transferee company.
2. Investment Allowance Reserve is a
   A capital reserve
   B statutory reserve
   C none of A or B.

3. For calculating purchase consideration as per AS—14,
   A only payment to equity shareholders are to be taken into consideration
   B only payment to shareholders are to be taken into consideration
   C payments to shareholders as well as debentureholders are to be taken into consideration.
4. Under pooling of interests method, all costs associated with the amalgamation are
   A capitalised
   B expended as incurred
   C none of the above.
5. In an amalgamation in the nature of merger
   A all assets and liabilities are taken over by the transferee company at agreed value
   B all assets and liabilities are taken over by the transferee company at book value
   C none of the above.

PRACTICAL QUESTIONS

Calculation of Purchase Consideration as per AS—14

1. A Ltd. is absorbed by B Ltd., the consideration being the takeover of liabilities, the payment of cost of absorption as part of purchase consideration not exceeding ₹ 10,000; the payment of the debentures of ₹ 15 lakh at a premium of 10% and the payment of ₹ 15 per share in cash and allotment of one 10% preference share of ₹ 10 each and five equity shares of ₹ 10 each fully paid for every four shares in A Ltd. The number of shares of A Ltd. are 2 lakh of ₹ 10 each fully paid.
   Compute the amount of consideration.
2. On 1.4.2016, A Ltd. had the following capital structure :

	₹
1,00,000 Equity Shares of ₹ 10 each	10,00,000
10,000, 12% Preference Shares of ₹ 10 each	1,00,000
50,000, 10% Debentures of ₹ 10 each	5,00,000
	16,00,000

   On the above date, B Ltd. absorbed A Ltd. under the following terms and conditions :
   (1) B Ltd. will take over all the assets and liabilities of A Ltd. at book value.
   (2) B Ltd. will pay for —
   Equity shareholders — 50,000 equity shares of ₹ 10 each and 5,000, 12% debentures of ₹ 100 each.
   Preference shareholders — 13% preference shares of an equal amount.
   Debentureholders — to be redeemed by B Ltd. at par.
   Liquidation expenses — ₹ 25,000.
   You are required to calculate purchase consideration.
3. Below is given the Balance Sheet of B Co Ltd. as on 1.4.2016 :

Balance Sheet of B Co. Ltd. as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 30,000 Equity Shares of ₹ 10 each fully paid		3,00,000
(b) Reserves and Surplus — General Reserve		30,000
Profit and Loss Account		15,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term borrowings — 10% Debentures		1,50,000
(4) Current Liabilities :		
(a) Trade Payables		20,000
(b) Other Current Liabilities — Provident Fund		5,000
TOTAL		5,20,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets : Land and Building		95,000
Plant and Machinery		2,00,000
(ii) Intangible assets :		
Goodwill		25,000
Patents		7,500
(2) Current Assets :		
(a) Current investments		10,000
(b) Inventories		1,06,000
(c) Trade receivables		40,000
(d) Cash and cash equivalents		36,500
TOTAL		5,20,000

A Co Ltd. absorbed the above company on the same date on the basis of the Balance Sheet given and on the following terms and conditions :

(1) It would issue 12% debentures in A Co Ltd. to discharge the debenture debt at a premium of 5%.

(2) It would pay ₹ 10,000 as cost of liquidation.

(3) It would pay cash @ ₹ 3 per share and exchange 3 shares of ₹ 10 each (market value ₹ 15) for every 5 shares in B Co Ltd.

You are required to calculate the purchase consideration.

4. The abstract of the Balance Sheet of the AXE Ltd as at 31st March, 2016 are as follows :

Liasbilities	₹
Equity share capital (₹ 100 each)	15,00,000
12% Preference share capital (₹ 100 each)	8,00,000
13% Debentures	3,00,000

On 31st March, 2016 BXE Ltd agreed to take over AXE Ltd on the following terms :

(1) For each preference share in AXE Ltd ₹ 10 in cash and one 9% preference share of ₹ 100 in BXE Ltd.

(2) For each equity share AXE Ltd ₹ 20 in cash and one equity share in BXE Ltd of ₹ 100 each. It was decided that the share in BXE Ltd will be issued at market price of ₹ 140 per share.

(3) Liquidation expenses of AXE Ltd are to be reimbursed by BXE Ltd to the extent of ₹ 10,000. Actua expenses amounted to ₹ 12,500.

You are required to compute the amount of purchase consideration.

Closing of Books of Account of Transferor Company

5. The following are the summarised Balance Sheets of X Ltd. and Y Ltd.

Balance Sheets of X Ltd. and Y Ltd. as at . . .

Particulars	Note No.	X Ltd. (₹)	Y Ltd. (₹)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		1,00,000	50,000
(b) Reserves and Surplus — Profit and Loss		10,000	(10,000)
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term borrowings — Loan from X Ltd.		—	15,000
(b) Trade Payables — Creditors		25,000	5,000
TOTAL		1,35,000	60,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		1,20,000	60,000

(2) Current Assets :			
(a) Short-term loans and advances — Loan to Y Ltd.		15,000	—
TOTAL		1,35,000	60,000

A new company XY Ltd. is formed to acquire the sundry assets and creditors of X Ltd. and Y Ltd. and for this purpose, the sundry assets of X Ltd. are revalued at ₹ 1,00,000. The debt due to X Ltd. is also to be discharged in shares of XY Ltd.

Show the Ledger Accounts to close the books of X Ltd. ***[C.A. (Inter) — Adapted]***

6. The following is the Balance Sheet of A Co Ltd. as on 1st April, 2016 :

Balance Sheet of A Co. Ltd. as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 2,000 Equity Shares of ₹ 10 each		2,00,000
(b) Reserves and Surplus — General Reserve		50,000
Profit and Loss Account		20,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		1,00,000
(a) Long-term borrowings — 12% Debentures		
(4) Current Liabilities :		
(a) Trade Payables		30,000
TOTAL		4,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		1,50,000
Plant and Machinery		83,000
(ii) Intangible assets — Goodwill		50,000
(2) Current Assets :		
(a) Inventories		35,000
(b) Trade receivables — Debtors		32,000
(c) Cash and cash equivalents — Cash at Bank		50,000
TOTAL		4,00,000

B Co Ltd. agreed to take over the assets (exclusive of cash and goodwill at 10% less than book values, to pay ₹ 75,000 for goodwill) and to take over the debentures.

The purchase consideration was to be discharged by the issue of 1,650 equity shares of ₹ 100 each and the balance in cash. The cost of liquidation amounted to ₹ 3,000.

You are required to close the books of A Co Ltd.

7. Exe Limited was wound up on 31.3.2016 and its Balance Sheet as on that date is given below :

Balance Sheet of Exe Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,20,000 Equity Shares of ₹ 10 each		12,00,000
(b) Reserves and Surplus — Profits prior to Incorporation		42,000
Contingency Reserve		2,70,000
Profit and Loss Account		2,52,000
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade payables :		
Bills Payable		40,000
Sundry Creditors		2,26,000
(b) Short-term provisions — Income tax		2,20,000
TOTAL		22,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant		9,64,000
(2) Current Assets :		
(a) Inventories		7,75,000
(b) Trade receivables :		
Sundry Debtors		1,52,000
Bills Receivables		30,000
(c) Cash and cash equivalents — Cash at Bank		3,29,000
TOTAL		22,50,000

Wye Limited took over the following assets at values shown as under :
Plant ₹ 12,80,000; Inventories ₹ 7,70,000; and Bills Receivable ₹ 30,000.
Purchase consideration was settled by Wye Limited as under :
₹ 5,10,000 of the consideration was satisfied by the allotment of fully paid 10% Preference Shares of ₹ 100 each.
The balance was settled by issuing equity shares of ₹ 10 each of ₹ 8 per share paid up.
Sundry Debtors realised ₹ 1,50,000. Bills payable was settled for ₹ 38,000.
Income-tax authorised fixed the taxation liability at ₹ 2,22,000.
Creditors were finally settled with the cash remaininbg after meeting liquidation expenses amounting to ₹ 8,000.

You are required to :

(i) Calculate the number of equity shares and preference shares to be allotted by Wye Limited in discharge of purchase consideration.

(ii) Prepare the Realisation Account, Cash / Bank Account, Equity Shareholders Account and Wye Limited Account in the books of Exe Limited.

8. The Balance Sheet of Mars Limited as on 31st March, 2016 was as follows :

Balance Sheets of Mars Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,00,000 Equity Shares of ₹ 10 each fully paid		10,00,000
(b) Reserves and Surplus — Capital Reserve		42,000
Contingency Reserve		2,70,000
Profit and Loss Account		2,52,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables :		
Bills Payable		40,000
Sundry Creditors		2.26.000
(b) Short-term Provisions — Provision for Income tax		2,20,000
TOTAL		20,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Land and Building		7,64,000

(2) Current Assets :		
(a) Inventories		7,75,000
(b) Trade receivables :		
Sundry Debtors		1,52,000
Bills receivables		30,000
(c) Cash and cash equivalents — Cash at Bank		3,29,000
TOTAL		20,50,000

On 1st April, 2016 Jupiter Limited agreed to absorb Mars Limited on the following terms and conditions :

(1) Jupiter Limited will take over the assets at the following values : ₹

	₹
Land and Building	10,80,000
Inventories	7,70,000
Bills Receivable	30,000

(2) Purchase consideration will be settled by Jupiter Ltd as under :
4,100 fully paid 10% preference shares of ₹ 100 will be issued and the balance will be settled by issuing equity shares of ₹ 10 each at ₹ 8 paid-up.

(3) Liquidation expenses are to be reimbursed by Jupiter Ltd to the extent of ₹ 5,000.

(4) Sundry Debtors realised ₹ 1,50,000, Bills Payable were settled for ₹ 38,000. Income tax authorities fixed the taxation liability at ₹ 2,22,000 and the same was paid.

(5) Creditors were finally settled with cash remaining after meeting liquidation expenses amounting to ₹ 8,000.

You are required to :

(i) Calculate the number of equity shares and preference shares to be allotted by Jupiter Limited in discharge of purchase consideration.

(ii) Prepare the Realisation Account, Bank Account, Equity Shareholders Account and Jupiter Limited's account in the books of Mars Ltd. ***[C.A. IPCC — Adapted]***

Amalgamation in the Nature of Merger

9. The following are the Balance Sheets of A Ltd. and B Ltd. as on 31.3.2016 :

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		10,00,000	5,00,000
(b) Reserves and Surplus — General Reserve		2,50,000	1,50,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Creditors		4,50,000	2,00,000
TOTAL		17,00,000	8,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		4,00,000	1,00,000
Plant and Machinery		5,00,000	4,00,000
(b) Non-current investments :		1,00,000	1,00,000
(2) Current Assets :			
(a) Inventories		3,00,000	1,00,000
(b) Trade receivables		3,50,000	1,50,000
(c) Cash and cash equivalents — Cash at Bank		50,000	—
TOTAL		17,00,000	8,50,000

A new company C Ltd. was formed to take over the business of A Ltd. and B Ltd. — the purchase consideration being ₹ 12,00,000 for A Ltd. and ₹ 6,00,000 for B Ltd., payable in equity shares of ₹ 10 each in C Ltd.
Debtors of A Ltd. included ₹ 50,000 due from B Ltd. The stock of B Ltd. included ₹ 25,000 worth of goods purchased from A Ltd., on which A Ltd. made a profit of 20% on sales.
Show the journal entries in the books of A Ltd., B Ltd. and C Ltd. Also, prepare the Balance Sheet of C Ltd. as on 3.3.2016, assuming that the amalgamation is in the nature of merger.

10. Following are the Balance Sheets of A Ltd. and B Ltd. as on 1.4.2016 :

Balance Sheets of A Ltd. and B Ltd. as at 1st April, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		1,50,000	1,00,000
(b) Reserves and Surplus — General Reserve		35,000	30,000
Profit and Loss Account		15,000	10,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Trade Payables		50,000	35,000
TOTAL		2,50,000	1,75,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		75,000	60,000
Plant and Machinery		50,000	40,000
Furniture and Fixtures		40,000	25,000
(2) Current Assets :			
(a) Inventories		35,000	15,000
(b) Trade receivables		25,000	20,000
(c) Cash and cash equivalents		25,000	15,000
TOTAL		2,50,000	1,75,000

Two companies decided to amalgamate in the nature of merger. A new company, AB Ltd. is formed to take over all the assets and liabilities. The authorised share capital of AB Ltd. is 40,000 equity shares of ₹ 10 each — out of which 30,000 shares will be issued to A Ltd. and B Ltd. The market values of the land and building, and plant and machinery of the two companies are different from book values. For the purpose of calculating purchase consideration, assets and liabilities taken over at book values, subject to the following changes —

	A Ltd. (₹)	B Ltd. (₹)
Land and Building	90,000	65,000
Plant and Machinery	60,000	45,000

You are required to : (i) calculate purchase consideration; (ii) close the books of both the companies; (iii) pass opening journal entries in the books of AB Ltd.; and (iv) prepare the Balance Sheet of AB Ltd.

Amalgamation in the Nature of Purchase

11. The Balance Sheet of Moon Ltd. as on 31.3.2016 was as follows :

Balance Sheet of Moon Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 5,000 Equity Share of ₹ 100 each		5,00,000
(b) Reserves and Surplus — Profit and Loss Account		(1,65,000)

(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities : (a) Long-term borrowings — 9% Debentures		1,00,000
(4) Current Liabilities : (a) Trade Payables — Sundry Creditors		90,000
TOTAL		5,25,000
II. ASSETS		
(1) Non-current Assets : (a) Fixed Assets (i) Tangible Assets : Building Plant		 2,00,000 1,60,000
(2) Current Assets : (a) Inventories (b) Trade receivables — Debtors (c) Cash and cash equivalents — Cash at Bank		 30,000 1,20,000 15,000
TOTAL		5,25,000

Sun Ltd. was formed to take over the business of Moon Ltd. on the following terms :

(i) Preferential creditors to be paid ₹ 10,000 in full.

(ii) Ordinary creditors be given the option to either accept 50% of their claims in cash or convert their claims into 12% Debentures of Sun Ltd. (half the ordinary creditors opted for cash).

(iii) Debentures be discharged by the issue of sufficient number of 12% Debentures of Sun Ltd. as would bring the same amount of interest.

(iv) Shareholders be issued 2,000 Equity Shares of ₹ 100 each of Sun Ltd. at a premium of 20%.

(v) Liquidation expenses ₹ 5,000 be paid.

Prepare the necessary accounts to close the books of Moon Ltd. and prepare the Balance Sheet of Sun Ltd. assuming that the assets of Moon Ltd. are taken over at 25% discount.

12. Prosperous Ltd. has incurred exceptional losses and a scheme of reconstruction was approved by all the concerned parties. The Balance Sheet as at 31st March, 2016 showed :

Balance Sheet of Prosperous Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds : (a) Share Capital — (b) Reserves and Surplus — Profit and Loss Account	 (1) 	 16,80,000 (9,00,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities : (a) Long-term borrowings – Bank Loan (Secured)		12,00,000
(4) Current Liabilities : (a) Trade Payables — Preferential Creditors Other Creditors		 60,000 14,40,000
TOTAL		34,80,000
II. ASSETS		
(1) Non-current Assets : (a) Fixed Assets (i) Tangible Assets — Plant and Machinery		 18,00,000

(2) Current Assets :		
(a) Inventories at cost		7,20,000
(b) Trade receivables — Sundry Debtors		9,60,000
TOTAL		34,80,000

Notes to Accounts :

(1) Share Capital

Particulars	Prosperous Ltd. (₹)
Issued, Subscribed and Paid-up Capital :	
12,000 Equity Shares of ₹ 100 each	12,00,000
4,800 Cumulative Preference Shares of ₹ 100 each	4,80,000
	16,80,000

The scheme of reconstruction provided :

(a) a new company — Bright Ltd. — will be formed to take over the assets and liabilities of Prosperous Ltd. as at 31st March, 2016.

(b) 2,400 equity shares of ₹ 100 each in Bright Ltd., credited as ₹ 50 per share paid up, to be issued to the liquidator of Prosperous Ltd. for the benefit of that company's equity shareholders who had agreed to pay up the balance of ₹ 50 per share immediately.

(c) 4,800 preference shares of Bright Ltd., credited as ₹ 75 per share paid up to be issued to liquidation of Prosperous Ltd. for the benefit of that company's preference shareholders, who had agreed to pay the balance of ₹ 25 per share immediately. In addition, ₹ 57,600 in 14% debentures (redeemable after 5 years) are to be issued as compensation for arrears of preference dividends.

(d) Bright Ltd. to reimburse liquidation expenses of Prosperous Ltd. for ₹ 12,000.

(e) Bright Ltd. decided to adopt the following values for tangible assets acquired, viz.,
₹ 16,80,000 for Plant and Machinery; ₹ 6,00,000 for stock; ₹ 9,60,000 for trade debtors.

(f) Bright Ltd. immediately to discharge preferential creditors in cash.

(g) Bright Ltd. to fully satisfy 'other creditors' liability as under :
₹ 7,20,000 in cash; ₹ 3,60,000 in acceptance of a bill of exchange payable after 120 days; ₹ 3,60,000 in issue of 14% debentures (redeemable after 5 years).

(h) The authorised capital of Bright Ltd. will be ₹ 30,00,000 divided into 15,000, 12% cumulative preference shares of ₹ 100 each and 15,000 equity shares of ₹ 100 each.

(i) The directors of Bright Ltd. have agreed to subscribe for 8,400 equity shares of ₹ 100 each payable in full with application.

(j) Bright Ltd. decided to pay-off bank loan to the extent of ₹ 2,40,000 and the balance will be secured on fixed assets.

(k) Preliminary expenses of Bright Ltd. amounted to ₹ 24,000.

Assuming that all the above provisions of the scheme are fulfilled, you are required to show :

(a) In the books of Prosperous Ltd.: (i) Realisation Account; and (ii) Sundry Members Account; and

(b) (i) Journal entries (including for cash items) in the books of Bright Ltd., and
(ii) Opening Balance Sheet of Bright Ltd. ***[I.C.W.A. (Final) — Adapted]***

13. The following abridged Balance Sheet of S Co Ltd. as on 31.3.2016 is given below :

Balance Sheet of S Co. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	11,90,000
(b) Reserves and Surplus — Profit and Loss		(4,90,000)
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities : (a) Long-term borrowings — 10% Debentures		1,00,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		1,00,000
(b) Other current liabilities — Interest accrued on Debentures		10,000
TOTAL		9,10,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant and Machinery		6,00,000
(ii) Intangible assets — Goodwill		50,000
(2) Current Assets :		
(a) Inventories		1,00,000
(b) Trade receivables		1,20,000
(c) Cash and cash equivalents		40,000
TOTAL		9,10,000

Notes to Accounts :

(1) Share Capital

Particulars	Prosperous Ltd. (₹)
Issued, Subscribed and Paid-up Capital :	
69,000 Equity Shares of ₹ 10 each	6,90,000
50,000, 12% Preference Shares Capital of of ₹ 10 each	5,00,000
	11,90,000

The following scheme of reconstruction has been sanctioned by the court :

(1) A new company S S Co Ltd. is formed with 1,00,000 equity shares of ₹ 10 each.

(2) The new company will acquire all the assets and liabilities of S Co Ltd. on the following terms :

(a) Old company's debentures are paid by similar debentures in the new company. The outstanding interest on debentures are paid by the new company by issuing equal amount of equity shares at par.

(b) The creditors are paid for every ₹ 100 dues ₹ 15 in cash and 10 equity shares issued at par.

(c) Preference shareholders are to get equal number of equity shares, and for 1 year's arrear dividend, these shareholders will get 5 equity shares at par for each ₹ 100 due.

(d) The equity shareholders will get 1 equity share in the new company in exchange of 3 shares held.

(e) The new company will bear the reconstruction expenses of ₹ 10,000.

(3) Current assets are to be taken at their book values (except inventories which is to be reduced by ₹ 30,000).

(4) Remaining shares of the new company are to be issued at par and be fully paid.

Assuming the above scheme has been implemented, you are to show :

(a) In the books of S Co Ltd. : (i) New Company's Account; (ii) Realisation and Reconstruction (combined) Account; (iii) Equity Shareholders Account.

(b) In the books of S S Co Ltd. : (i) Journal entries recording the acquisition and other transactions; and (ii) Summarised Balance Sheet.

14. Star and Moon had been carrying on business independently. They agreed to amalgamate and form a new company Neptune Ltd. with an authorised share capital of ₹ 2,00,000 divided into 40,000 equity shares of ₹ 5 each.
On 31st March, 2016, the respective Balance Sheets of Star and Moon were as follows :

Particulars	Star (₹)	Moon (₹)
Fixed Assets	3,17,500	1,82,500
Current Assets	1,63,500	83,875
	4,81,000	2,66,375
Less: Current Liabilities	2,98,500	90,125
Representing Capital	1,82,500	1,76,250

Additional information :

(a) Revalued figures of Fixed and Current Assets were as follows :

Particulars	Star (₹)	Moon (₹)
Fixed Assets	3,55,000	1,95,000
Current Assets	1,49,750	78,875

(b) The debtors and creditors include ₹ 21,675 owed by Star to Moon. The purchase consideration is satisfied by issue of the following shares and debentures :

(i) 30,000 equity shares of Neptune Ltd., to Star and Moon in the proportion in the profitability of their respective business based on the average net profit during the last three years which were as follows :

Particulars	Star (₹)	Moon (₹)
2013-14 Profit	2,24,788	1,36,950
2014-15 (Loss) / Profit	(1,250)	1,71,050
2015-16 Profit	1,88,962	1,79,500

(ii) 15% debentures in Neptune Ltd., at par to provide an income equivalent to 8% return on capital employed in their respective business as on 31st March, 2016 after revaluation of assets.

You are required to : (1) Compute the amount of debentures and shares to be issued to Star and Moon; and (2) A Balance Sheet of Neptune Ltd., showing the position immediately after amalgamation.

15. Sagar Ltd. was formed on 1 January, 2016 with an authorised share capital of 5,00,000 equity shares of ₹ 10 each. 1,00,000 equity shares were issued for cash at a premium of ₹ 2.50 per share. No other transactions took place until 1 April 2016 when Sagar Ltd. agreed to buy the assets, including goodwill and assume the liabilities of River Ltd. and Canal Ltd. for a total of 4,00,000 of its shares.

For the purpose of determining the premium at which the shares of Sagar Ltd. were to be issued, fixed assets, current assets and liabilities are to be taken at their book values, goodwill is to be determined on the basis of two and half times the average profit of the past three years after deducting a standard profit at 10% on capital employed as on 31 March, 2016. The summarised Balance Sheet of River Ltd. and Canal Ltd. as on 31 March, 2016 were as follows :

Balance Sheets of River Ltd. and Canal Ltd. as at 31st March, 2016

Particulars	Note No.	River Ltd. (₹)	Canal Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		15,50,000	16,75,000
(b) Reserves and Surplus — Profit and Loss		9,50,000	75,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables		10,00,000	27,50,000
TOTAL		35,00,000	45,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		22,50,000	14,50,000
(2) Current Assets :			
(a) Other Current Assets		12,50,000	30,50,000
TOTAL		35,00,000	45,00,000

Operating profits for the last three years :

Particulars		River Ltd. ₹	Canal Ltd. ₹
Year ended 31 March,	2014	3,52,500	2,75,000
	2015	4,40,000	3,20,000
	2016	4,45,000	3,42,500

You are required to :

(a) calculate the number of shares to be issued by Sagar Ltd. to the shareholders of River Ltd. and Canal Ltd. respectively; and (b) prepare a Balance Sheet of Sagar Ltd. after completion of business purchases.

[I.C.W.A. (Final) — Adapted]

Inter-Company Investments

16. The following are the summarised Balance Sheets of X Ltd. and Y Ltd. as on 31.3.2016 :

Balance Sheets of X Ltd. and Y Ltd. as at 31st March, 2016

Particulars	Note No.	X Ltd. (₹)	Y Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		4,00,000	2,00,000
(b) Reserves and Surplus — Profit and Loss		50,000	—
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term borrowings — 15% Debentures		1,00,000	—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		1,50,000	1,40,000
TOTAL		7,00,000	3,40,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant		5,00,000	3,40,000
(b) Non-current investments — 15,000 Shares in Y Ltd.		2,00,000	—
(2) Current Assets :			
TOTAL		7,00,000	3,40,000

A new company, XY Ltd., is formed to acquire the entire business of X Ltd. and Y Ltd. For this purpose, Plant of X Ltd. were valued at ₹ 3,00,000 and Plant of Y Ltd. at ₹ 2,00,000. The purchase consideration is being discharged in shares of ₹ 10 each of new company. You are required to close the books of X Ltd. and Y Ltd.; pass journal entries in the books of XY Ltd. and to prepare the opening Balance Sheet.

17. All India Motels Ltd. absorbed the business of West India Motels Ltd. as on 31st March, 2016. Their respective position of assets and liabilities as on that date, prior to absorbtion were as under : [figures in ₹ lakhs]

Assets and Liabilities	All India Motels Ltd.	West India Motels Ltd.
Share Capital	600	600
Reserve and Surplus	540	360
Debentures	800	960
Sundry Creditors	220	480
Goodwill	448	320
Buildings	1,160	1,120
Machinery	180	160
Sundry Debtors	60	560
Inventories / Inventory	80	200
Cash	32	40
Investments	200	—

The intrinsic value of West India Motels Ltd.'s share has to be determined. Equivalent intrinsic value worth of ₹ 10 fully paid up shares of All India Motels Ltd. are to be issued to the shareholders of West India Motels Ltd.

50% of debtors of All India Motels Ltd. comprises money due from West India Motels Ltd.

Inventory of West India Motels Ltd. includes goods worth ₹ 30 lakhs sold by All India Motels Ltd. at cost plus 20%.

Value called and paid-up on All India Motels Ltd.'s share is ₹ 8 per share whilst it is ₹ 5 share in case of West India Motels Ltd.

Face value of shares of both the companies is ₹ 10. Half the investments of All India Motels Ltd. represents shares of West India Motels Ltd. at paid up value.

Pass necessary journal entries to record the above transaction in the books of All India Motels Ltd. and draw the Balance Sheet of All India Motels Ltd. after absorbtion (assuming that the amalgamation in the nature of purchase).

18. The Balance Sheets of Hot Ltd. and Cold Ltd. as on 31st March, 2016 were as follows :

Balance Sheets of Hot Ltd. and Cold Ltd. as at 31st March, 2016

Particulars	Note No.	Hot Ltd. (₹)	Cold Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		16,00,000	6,00,000
10% Preference Share Capital of ₹ 100 each		—	4,00,000
(b) Reserves and Surplus — General Reserve		6,00,000	2,00,000
Profit and Loss Account		3,00,000	1,40,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		4,00,000	6,00,000
TOTAL		29,00,000	19,40,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Building		4,00,000	2,00,000
Furniture		2,00,000	1,20,000
Machinery		10,00,000	6,00,000
(b) Non-current investments — 12,000 Equity Shares in Cold Ltd.		1,20,000	—
(2) Current Assets :			
(a) Inventories		3,00,000	3,80,000
(b) Trade receivables — Sundry Debtors		7,00,000	5,00,000
(c) Cash and cash equivalents		1,80,000	1,40,000
TOTAL		29,00,000	19,40,000

Hot Ltd. has taken over the entire undertaking of Cold Ltd. on 30th September, 2016. The position of current assets and current liabilities except cash and bank balances as on that date was as under : [figures in ₹]

Particulars	Hot Ltd.	Cold Ltd.
Inventories	2,40,000	3,00,000
Sundry Debtors	7,60,000	5,00,000
Sundry Creditors	3,60,000	4,20,000

Profits earned for the half-year ended on 30th September, 2015 were :

Hot Ltd. — ₹ 2,05,000; Cold Ltd. — ₹ 1,08,000.

The above profits have been arrived at after charging depreciation at 5% per annum on building, 15% per annum on machinery and 10% per annum on furniture.

On 30th August, 2016 both companies declared and paid 15% dividend on equity shares for 2015-16. Goodwill of Cold Ltd. has been valued at ₹ 1,00,000 and other fixed assets at 10% above their book values on 31st March, 2015. Preference shareholders of Cold Ltd. are to be allotted 10% preference shares of ₹ 100 each of Hot Ltd. and equity shareholders of Cold Ltd. are to receive requisite number of equity shares of Hot Ltd. valued at ₹ 15 per share in satisfaction of their claims.

Prepare the Balance Sheet of Hot Ltd. as of 30th September, 2016 assuming absorbtion is throught by that date.

19. B Ltd. is absorbed by A Ltd. on 31st March, 2016 on the basis of the following Balance Sheets :

Balance Sheet of A Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 2,00,000 Equity Share of ₹ 5 each fully paid		10,00,000
(b) Reserves and Surplus — General Reserve		2,50,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		2,50,000
TOTAL		15,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Factory Shed		5,00,000
Machinery		3,00,000
Furniture		50,000
(b) Non-current investments :		
500 Shares in B Ltd.		50,000
Debenturs in B Ltd.		50,000
Others		70,000
(2) Current Assets :		
(a) Inventories		2,20,000
(b) Trade receivables		2,00,000
(c) Cash and cash equivalents		60,000
TOTAL		15,00,000

Balance Sheet of B Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 5,000 Equity Shares of ₹ 100 each fully paid		5,00,000
(b) Reserves and Surplus — Profit and Loss Account		(1,20,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 6% Debentures (₹ 1,000 each)		3,00,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		3,00,000
TOTAL		9,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		—
(b) Non-current investments — 40,000 Equity Shares in A Ltd.		2,00,000
(2) Current Assets :		
(a) Inventories		5,00,000
(b) Trade receivables — Sundry Debtors		2,50,000
(c) Cash and cash equivalents — Cash at Bank		30,000
TOTAL		9,80,000

The following is the scheme of absorption :

(i) Prior to absorption A Ltd. was to declare a dividend of 25%.

(ii) For every share in B Ltd. 14 fully paid-up equity shares in A Ltd. were to be issued.

(iii) For each debenture in B Ltd. 10, $7^1/_2$% preference shares of ₹ 100 each of A Ltd. were to be issued as fully paid.

Directors of A Ltd. decided to revalue the shares in B Ltd. according to their intrinsic value just before absorption. Draw-up Balance Sheet of A Ltd. after absorption is completed. Show necessary workings.

20. Following are the Balance Sheets of A Ltd. and B Ltd. as on 31.3.2016 :

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	40,00,000	10,00,000
(b) Reserves and Surplus — General Reserve		30,00,000	5,00,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings			
(4) Current Liabilities :			
(a) Other Current Liabilities		30,00,000	1,00,000
(b) Short-term Provisions — Provision for Tax		—	1,00,000
Proposed Dividend		—	1,00,000
TOTAL		1,00,00,000	18,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		30,00,000	4,00,000
(b) Non-current investments		5,00,000	—
(2) Current Assets :			
(a) Other Current Assets		65,00,000	14,00,000
TOTAL		1,00,00,000	18,00,000

Notes to Accounts :

(1) Share Capital

Particulars	A Ltd. (₹)	B Ltd. (₹)
Issued, Subscribed and Paid-up Capital :		
40,000 Equity Shares of ₹ 100 each fully paid	40,00,000	—
20,000 Equity Shares of ₹ 50 each fully paid	—	10,00,000
	40,00,000	10,00,000

B Ltd. is to be absorbed by A Ltd. on the following terms :

(1) B Ltd. declares a dividend of 10% before absorption for the payment of which it is to retain sufficient amount of cash.

(2) For the purpose of absorption each share of B Ltd. is worth ₹ 72.50.

(3) The purchase consideration is satisfied by the issue of fully paid-up shares of ₹ 100 each in A Ltd.

(4) All assets and liabilities are taken over at book value except fixed assets and stock. Fixed assets were valued at ₹ 3,50,000.

Following further information is also to be taken into consideration :

(a) A Ltd. holds 5,000 shares of B Ltd. at a cost of ₹ 3,00,000.

(b) The stocks of B Ltd. include items valued at ₹ 1,00,000 purchased from A Ltd. (cost to A Ltd. ₹ 75,000).

(c) The creditors of B Ltd. include ₹ 50,000 due to A Ltd.

Show Ledger Accounts in the books of B Ltd. to give effect of the above and Balance Sheet of A Ltd. after completion of the absorption.

Guide to Answers

Multiple Choice

1. C; 2. B; 3. B; 4. B; 5. B.

Practical Question

1. Purchase consideration ₹ 60,00,000.
2. Purchase consideration—₹ 11,00,000.
3. Purchase consideration—₹ 3,60,000.
4. Purchase consideration — ₹ 32,80,000.
5. Realisation Loss—₹ 20,000.
6. Purchase consideration—₹ 2,45,000; Realisation Loss—₹ 8,000.
7. Purchase consideration — ₹ 20,80,000; Number of Preference Shares to be issued — 5,100 shares. Number of Equity Shares to be issued — 1,96,250 shares. Profit on realisation — ₹ 3,16,000.
8. Purchase consideration — ₹ 18,80,000; Number of Preference Shares to be issued — 4,100 shares; Number of Equity Shares to be issued — 1,83,750 shares. Profit on realisation — ₹ 3,16,000.
9. Realisation Loss : A Ltd.—₹ 50,000 and B Ltd.—₹ 50,000; Total reserve—₹ 95,000.
10. Purchase consideration : ₹ 3,00,000 (30,000 × ₹ 10) will be shared by A Ltd. and B Ltd. in ratio of ₹ 2,25,000 and ₹ 1,50,000 (i.e., the ratio of networth). The purchase consideration : A Ltd.—₹ 1,80,000 and B Ltd.—₹ 1,20,000. Realisation Loss : A Ltd.—₹ 20,000; B Ltd.—₹ 20,000. Balance of Reserve Account : A Ltd.—₹ 5,000; and B Ltd.—₹ 10,000. Balance Sheet total—₹ 4,25,000.
11. Purchase consideration—₹ 3,90,000. Realisation Loss—₹ 95,000; Capital Reserve—₹ 7,500.
12. Loss on realisation—₹ 3,00,000; Capital reserve—₹ 2,400.

13. Purchase consideration—₹ 7,60,000; Profit on realisation and reconstruction—₹ 30,000. Goodwill—₹ 1,55,000; Balance Sheet total — ₹ 11,00,000.
14. Purchase consideration : Star Ltd.—₹ 1,78,750; Moon Ltd.—₹ 1,79,250. Equity Shares issued : Star—13,750; Moon—16,250. Debentures issued : Star — 16,500; Moon — 14,700. Total of Balance Sheet — ₹ 7,56,950. Capital Reserve ₹ 32,000.
15. Value of Goodwill : River Ltd.—₹ 4,06,250; Canal Ltd.—₹ 3,43,750. Net Assets : River Ltd.—₹ 29,06,250; Canal Ltd.—₹ 20,93,750. Total Net Assets : ₹ 50,00,000. Value of each share : ₹ 50,00,000 / 4,00,000 = ₹ 12.50. No. of shares issued : River Ltd. — ₹ 29,06,250 / ₹ 12.50 = 2,32,500 shares; Canal—20,93,750 / ₹ 12.50 = 1,67,500 shares.
Total of Balance Sheet — ₹ 100,00,000.
16. Realisation Loss : X Ltd. — ₹ 35,500; Y Ltd. — ₹ 14,000.
17. Intrinsic value per share of West India Motels Ltd. — ₹ 8 (paid up ₹ 5 per share); All India Motels Ltd. — ₹ 16 (paid up ₹ 8 per share). Value per fully paid shares of All India Motels Ltd. will be : 16 / 8 × ₹ 10 = ₹ 20.
Purchase consideration :

Total no. of shares	**120 lakhs**
Less: Shares held by All India Motels Ltd.	**20 lakhs**
Outside shareholders	**100 lakhs**

Price payable per share ₹ 8. Therefore, purchase consideration will be : ₹ 8 × 100 = ₹ 800 lakhs. No. of shares will be issued: 800 lakhs / ₹ 20 = 40 lakhs. Balance Sheet total ₹ 4,370 lakhs.33.
18. Purchase consideration — ₹ 15,00,000; Set-off for 12,000 shares held by Hot Ltd. — ₹ 2,22,000; Net amount payable to outside shareholders — ₹ 8,88,000.
No. of shares of ₹ 10 each to be issued 59,200 at a premium of ₹ 5 per share.
19. Capital Reserve — ₹ 65,000.
20. Realisation Loss ₹ 50,000.

11

Capital Reduction/ Internal Reconstruction

Meaning

Capital Reduction is the repayment or writing down of a company's different classes of capital, as a result of large accumulated losses or an excess of funds without profitable use.

Though Capital Reduction may be effected when a company accumulates huge surplus funds far in excess of its requirements, but it is more usually followed, when a company passes through a period of financial difficulties, accumulates losses or has its assets over-valued.

Objective of Capital Reduction

When new capital has to be introduced to revive a company, the success of a new issue would however, almost certainly be jeopardised by the existence of accumulated losses. Therefore, it is prudent and usual to write-off these losses by putting a reconstruction scheme into effect.The objective of Capital Reduction is the resumption of the payment of normal dividends out of the expected future profits without the necessity of using those profits to write-off the debit balance of the Profit and Loss Account.

Reduction of Share Capital Under the Companies Act, 2013

As per the provision of Section 66 of the Companies Act, 2013, a Company limited by shares or limited by guarantee and having share capital may reduce share capital after the confirmation by the Tribunal on an application made by the Company.

If the Tribunal is satisfied that the debt or claim of every creditor of the Company has been discharged or determined or has been secured or his consent is obtained, it may confirm the Capital Reduction.

However, it may impose terms and conditions as it deems fit.

It is important to mention here that no such reduction shall be made if the Company is in arrears in the repayment of any deposits accepted by it, either before or after the commencement of this Act, or interest payable thereon.

Procedure

In order to effect reduction of share capital, the following formalities must be completed :

(i) The Company must pass a Special Resolution for reduction of share capital.

(ii) The order of confirmation of the reduction of share capital by the Tribunal shall be published by the Company in such manner as the Tribunal may direct.

(iii) The Company shall deliver a certified copy of the order of the Tribunal and of the minute approved by the Tribunal to the Registrar within 30 days of the receipt of the copy of the order, who shall register the same and issue a certificate to that effect.

Form of Reduction

The reduction of share capital may take any of the following forms :

(i) The Company may extinguish or reduce the liability on any of its shares in respect of the share capital not paid-up; or

(ii) The Company may pay-off any paid-up share capital which is in excess of the wants of the Company; or

(iii) The Company may cancel any paid-up share capital which is lost or is unrepresented by available assets.

Accounting Arrangements

When the Company extinguish or reduce the liability of the shareholders in respect of any unpaid amount on the shares held by them

This form of capital reduction benefits the shareholders inasmuch as they will not be called upon to pay the ***uncalled*** amount. In this case, the paid-up share capital of the company will remain the same.

Journal Entry

Share Capital (Partly paid-up) Account Dr.
To Share Capital (Fully paid-up) Account

Illustration 1

ABC & Co. Ltd. had on 31st December, 2015, 80,000 Equity Shares of ₹ 10 each, ₹ 8 per share called-up. In July, 2016, the company decided to reduce it to ₹ 8 per share fully paid-up by cancelling unpaid amount of ₹ 2 per share.

You are required to pass necessary Journal Entries and show how the paid-up capital will appear in the Balance Sheet as on 31st December, 2015 and 2016.

Solution

In the books of ABC & Co. Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 July	Equity Share Capital (Partly paid-up) A/c Dr.		6,40,000	
	To Equity Share Capital (Fully paid-up) A/c			6,40,000
	(Being cancellation of unpaid amount @ ₹ 2 on 80,000 sh. of ₹ 10 each to reduce them to 80,000 sh. of ₹ 8 each fully paid as per Special Resolution no. ... dated ... as confirmed by Tribunal)			

ABC & Co Ltd
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,40,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
80,000 Equity Shares of ₹ 10 each, ₹ 8 per share called-up	6,40,000

ABC & Co Ltd
Balance Sheet as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,40,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
80,000 Equity Shares of ₹ 8 each fully paid up	6,40,000

When the Company paid off any paid-up share capital which is in excess of the wants of the Company

Sometimes, it may not be possible on the part of the company to employ profitably all the capital received. In such a case, it may decide to return ***excess capital*** to the shareholders. It should be noted that the paid-up capital of the company will be reduced by the amount paid-off.

Journal Entries

(i) Share Capital Account Dr. [Amount paid-off]
    To Shareholders Account
(ii) Shareholders Account Dr.
    To Bank Account

Illustration 2

ABC & Co. Ltd. had on 31st December, 2015, ₹ 4,00,000 authorised capital divided into 40,000 Equity Shares of ₹ 10 each. All these shares were issued and fully paid-up. In June 2016, the company decided to pay-off ₹ 2 per share to make the share of ₹ 8 fully paid-up. Pass necessary Journal Entries and show how the share capital will appear in the Balance Sheet as on 31st December, 2015 and 2016.

Solution

In the books of ABC & Co. Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 June	Equity Share Capital A/c Dr.		80,000	
	To Equity Shareholders A/c			80,000
	(Being the amount payable to shareholders @ ₹ 2 on 40,000 shares as per Special Resolution no. ... dated ... as confirmed by the Tribunal)			
	Equity Shareholders A/c Dr.		80,000	
	To Bank A/c			80,000
	(Being the amount paid to Equity shareholders)			

ABC & Co Ltd
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
40,000 Equity Shares of ₹ 10 each	4,00,000
Issued and Subscribed Capital :	
40,000 Equity Shares of ₹ 10 each fully paid up	4,00,000

ABC & Co Ltd
Balance Sheet as at 31st December, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,20,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
50,000 Equity Shares of ₹ 8 each	4,00,000
Issued and Subscribed Capital :	
40,000 Equity Shares of ₹ 8 each fully paid up	3,20,000

When the Company cancelled any paid-up share capital which is lost or is unrepresented by available assets

A life cycle exists for businesses as well as for individuals. When a business fail, large amount of losses are incurred, the book values of the assets shown are much higher than their fair market value. There are a variety of reasons for business failures, but it need not necessarily result in the collapse and dissolution of a company.

Liquidation is the final step for financially distressed businesses. Prior to that, however, the management usually tries to work closely with the company's creditors and lenders to provide for their claims, while also attempting to ensure the continuation of the firm. In such a case, capital is ***written down*** and the amount thus reduced is used to write-off the 'debit' balance of Profit and Loss Account / Statement of Profit and Loss, intangible assets and other over-valued assets.

Sometimes, creditors, lenders and debentureholders may be called upon to sacrifice a portion of their claims to make the business stand on its own feet, which will be to the advantage of all.

Some of the causes of business failure are as follows :

(1) Management inefficiency, i.e., poor management.
(2) State of trade and/or economy, which affects the concern as well as the industry as a whole.
(3) Completion of the life cycle of the concern meaning thereby end of the expansion phase.
(4) Overexpansion or ramification.
(5) Unforeseen internal or external disaster like certain demise of the business propeller and struggle for power among his successors, or certain cessation of hostilities like the Vietnam which delivered a blow to the American ordinance industries.
(6) Inavailability to innovate as per new invention like the computer.

Besides, underhightened trade unionism and hostile work culture may also cut at the root of a healthy business unit.

Journal Entries

1. For replacement of share of one denomination by the share of another denomination

Share Capital (Old denomination) Account	Dr.	[Paid-up value of old shares]
To Share Capital (New denomination) Account		[Paid-up value of new shares]
To Capital Reduction/Reconstruction Account		[Difference]

2. For reducing called-up Share Capital (without changing denomination)

Share Capital Account	Dr.	[Amount reduced]
To Capital Reduction/Reconstruction Account		

3. For surplus on revaluation of fixed assets

Individual Fixed Asset Account	Dr.	[Amount of appreciation]
To Capital Reduction/Reconstruction Account		

4. For waiver of preference dividend arrears by an issue of shares/debentures

Capital Reduction/Reconstruction Account	Dr.
To Share Capital Account	
To Debentures Account	

5. For issue of shares/debenture against accrued interest already provided in the Balance Sheet

Accrued Interest Account	Dr.
To Share Capital Account	
To Debentures Account	
To Capital Reduction/Reconstruction Account	

6. For transfer of favourable balance on reserve accounts

Individual Reserve Account	Dr.
To Capital Reduction/Reconstruction Account	

7. For expenses incurred on reconstruction

Capital Reduction/Reconstruction Account Dr.
    To Bank Account

8. For writing-off the fictitious assets and other assets

Capital Reduction/Reconstruction Account Dr.
    To Profit and Loss Account
    To Goodwill Account
    To Plant and Machinery Account
    To Patents Account
    To Stock Account

9. For capitalisation of surplus on Capital Reduction Account

Capital Reduction/Reconstruction Account Dr.
    To Capital Reserve Account

Points to Remember

At the time of preparing Balance Sheet after reconstruction is duly carried out, the following matters should be taken into consideration.

1. ***If the Tribunal orders, the words "and reduced" should be added after the name of the company for certain period.***
2. ***In respect of fixed assets, the amount written-off under a scheme of reconstruction must be shown for five years.***

Illustration 3

The following is the Balance Sheet of Weak Co Ltd as on 31st March, 2016 :

Balance Sheet of Weak Co. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,00,000 Equity Shares of ₹ 10 each fully paid		10,00,000
(b) Reserves and Surplus — Profit and Loss Account		(5,50,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		1,73,000
TOTAL		6,23,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land		1,00,000
Plant and Machinery		2,30,000
Furniture and Fitting		68,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,50,000
(c) Trade Receivables — Sundry Debtors		70,000
(d) Cash and Cash Equivalents — Cash in Hand		5,000
TOTAL		6,23,000

The approval of the Tribunal was obtained for the following scheme of reduction of capital:
(i) The equity shares to be reduced to ₹ 4 per share;
(ii) Plant and machinery to be written down to ₹ 1,50,000;
(iii) Inventory to be revalued at ₹ 1,40,000;
(iv) The provision on debtors for doubtful debts to be created at ₹ 2,000; and (v) land to be revalued at ₹ 1,42,000.
Pass journal entries to give effect to the above arrangement and also prepare Capital Reduction Account.

Solution

In the books of Weak Co Ltd
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 March 31	Equity Share Capital (₹ 10) A/c Dr.		10,00,000	
	To Equity Share Capital (₹ 4) A/c			4,00,000
	To Capital Reduction A/c			6,00,000
	(Being 1,00,000 equity shares of ₹ 10 each fully paid reduced to equity shares of ₹ 4 each fully paid as per Special Resolution No. ... dated ... confirmed by the Tribunal *vide* Order dated . . .)			
	Land A/c Dr.		42,000	
	To Capital Reduction A/c			42,000
	(Being the appreciation in the value of land transferred to Capital Reduction Account)			
	Capital Reduction A/c Dr.		6,42,000	
	To Plant and Machinery A/c			80,000
	To Inventory A/c			10,000
	To Provision for Doubtful Debts A/c			2,000
	To Profit and Loss A/c			5,50,000
	(Being the balance of Capital Reduction Account used for writing off Profit and Loss Account (Dr.) balance, and for writing down the balance of plant and machinery, stock and debtors as per scheme of reconstruction)			

Dr. Capital Reduction Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Plant and Machinery A/c	80,000	2016	By Equity Share Capital A/c	6,00,000
March 31	To Inventories A/c	10,000	March 31	By Land A/c	42,000
	To Provision for Doubtful Debts A/c	2,000			
	To Profit and Loss A/c	5,50,000			
		6,42,000			6,42,000

Illustration 4

The paid-up capital of S Ltd., amounted to ₹ 5,00,000, consisting of 50,000 equity shares of ₹ 10 each.

Due to losses incurred by the company continuously, the directors of the company prepared a scheme of reconstruction which was duly approved by the Tribunal.

The terms of reconstruction were as under :
(i) In lieu of their present holdings, the shareholders are to receive:
Fully paid equity shares equal to 2/5ths of their present holding.
12% preference shares fully paid-up, to the extent of 25% of the above new equity shares.
5,000, 11% second debentures of ₹ 10 each.
(ii) An issue of 5,000, 10% first debentures of ₹ 10 each was made and allotted; payment for the same being received in cash forthwith.
(iii) The assets were reduced as follows :
Goodwill from ₹ 3,00,000 to ₹ 1,50,000;
Machinery from ₹ 1,00,000 to ₹ 75,000; and
Leasehold premises from ₹ 1,50,000 to ₹ 1,25,000.

Pass journal entries to give effect to the above mentioned scheme of reconstruction and show Capital Reorganisation Account. ***[C.S. (Inter) — June, 2000] and [C.A. (Inter) — November, 1995]***

Solution

In the books of S Ltd
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
?	Equity Share Capital (Old) A/c Dr.		5,00,000	
	To Equity Share Capital (New) A/c			2,00,000
	To 12% Preference Share Capital A/c			50,000
	To 11% Second Debentures A/c			50,000
	To Capital Reorganisation A/c			2,00,000
	(Being the conversion of existing 50,000 equity shares into 20,000 equity shares of ₹ 10 each fully paid; 5,000, 12% preference shares of ₹ 10 each fully paid and 5,000, 11% second debentures of ₹ 10 each fully paid and balance amount transferred to Capital Reorganisation Account as per scheme of reconstruction confirmed by the Tribunal *vide* Order No. . . .)			
	Capital Reorganisation A/c Dr.		2,00,000	
	To Goodwill A/c			1,50,000
	To Machinery A/c			25,000
	To Leasehold Premises A/c			25,000
	(Being the balance of Capital Reorganisation Account used for writing off goodwill to the extent of ₹ 1,50,000, Machinery Account to the extent of ₹ 25,000 and leasehold premises to the extent of ₹ 25,000 as per the scheme of reconstruction)			
	Bank A/c Dr.		50,000	
	To 10% First Debentures Application A/c			50,000
	(Being application money received on 5,000 debentures @ ₹ 10 each)			
	10% First Debentures Application A/c Dr.		50,000	
	To 10% First Debentures A/c			50,000
	(Being the issue of 5,000, 10% first debentures as per Board's Resolution No. . . . dated . . .)			

Dr. Capital Reorganisation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Goodwill A/c	1,50,000	?	By Equity Share Capital A/c	2,00,000
	To Machinery A/c	25,000			
	To Leasehold Premises A/c	25,000			
		2,00,000			2,00,000

Illustration 5

The following was the Balance Sheet of a Sick Company Ltd as on 31st March, 2016 :

Balance Sheet of Sick Company Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,33,000
(b) Reserves and Surplus	(2)	(66,900)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		46,275
(c) Short-term Provisions — Provision for Taxes		12,000
TOTAL		3,24,375

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		61,500
Machinery		1,52,550
(ii) Intangible Assets :		
Goodwill		30,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		30,825
(c) Trade Receivables — Book Debts		45,000
(d) Cash and Cash Equivalents — Cash at Bank		4,500
TOTAL		3,24,375

Notes to Accounts :

(1) Share Capital

Particulars		
Authorised Capital :		
60,000 Equity Shares of ₹ 10 each		6,00,000
Issued and Subscribed Capital :		
36,000 Equity Shares of ₹ 10 each	3,60,000	
Less: Calls-in-arrear (@ ₹ 3 per share on 9,000 shares)	27,000	3,33,000
(2) Reserve and Surplus		
Profit and Loss A/c Balance		(73,200)
Less: Profit for the year		6,300
		(66,900)

The directors have had a valuation made of the machinery and find it over valued by ₹ 30,000. It is proposed to write down this asset to its true value and to extinguish the deficiency in the Profit and Loss Account and to write off Goodwill and Preliminary Expenses by the adoption of the following course :

(i) Forfeit the shares on which the call is outstanding.
(ii) Reduce the paid-up capital by ₹ 3 per share.
(iii) Reissue the forfeited shares at ₹ 5 per share.
(iv) Utilise the provision for taxation, if necessary.

The shares on which the calls were in arrear were duly forfeited and reissued on payment of ₹ 5 per share. You are required to draft the journal entries necessary to carry out terms of the scheme.

Solution

In the books of Sick Company Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Equity Share Capital A/c	Dr.		90,000	
April 1	To Calls-in-Arrear A/c				27,000
	To Forfeited Shares A/c				63,000
	(Being the forfeiture of 9,000 equity shares of ₹ 10 each for non-payment call @ ₹ 3 per share as per Board's Resolution No. ... dated ...)				
	Equity Share Capital (₹ 10) A/c	Dr.		2,70,000	
	To Equity Share Capital A/c				1,89,000
	To Capital Reduction A/c				81,000
	(Being 27,000 equity shares of ₹ 10 each fully paid reduced to equity shares of ₹ 7 each fully paid as per Special Resolution No. ... dated ... confirmed by the Tribunal vide Order No. ...)				
	Bank A/c (9,000 x 5)	Dr.		45,000	
	Forfeited Shares A/c (9,000 x 2)	Dr.		18,000	
	To Equity Share Capital A/c				63,000
	(Being the re-issue of 9,000 equity shares of ₹ 7 each @ ₹ 5 as per Board's Resolution No. ... dated ...)				

Forfeited Shares A/c Dr. To Capital Reserve a/c (Being the profit on re-issue transferred to Capital Reserve Account as per the requirement of the Act)		45,000	45,000
Capital Reduction A/c Dr. Capital Reserve A/c Dr. Provision for Taxation A/c Dr. To Profit and Loss A/c To Goodwill A/c To Machinery A/c (Being the balance of Capital Reduction Account, Capital Reserve Account and Provision for Taxation Account used for writing off Profit and Loss Account (Dr.) balance, goodwill and machinery as per scheme of reconstruction)		81,000 45,000 900	 66,900 30,000 30,000

Illustration 6

The Balance Sheet of Eknath & Co. Ltd. as on 31.3.2016 is as follows :

Balance Sheet of Eknath & Co. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,00,000
(b) Reserves and Surplus — Profit and Loss Account Balance		(5,50,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 6% Debentures		4,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		3,30,000
(c) Other current liabilities — Accrued interest on debentures		24,000
TOTAL		14,04,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land		5,00,000
Plant		1,00,000
(ii) Intangible Assets :		
Patent		38,000
Goodwill		1,22,000
(2) Current Assets :		
(a) Current Investments		60,000
(b) Inventories		4,00,000
(c) Trade Receivables — Sundry Debtors		4,50,000
(d) Cash and Cash Equivalents — Bank Overdraft		(2,66,000)
TOTAL		14,04,000

Notes to Accounts :

(1) Share Capital

Particulars	
Authorised Capital :	
? Equity Shares of ₹ ? each	?
? Preference Shares of ₹ ? each	?
	?
Issued, Subscribed and Paid-up Capital :	
70,000 Equity Shares of ₹ 10 each fully paid	7,00,000
5,000, 10% Cumulative Preference Shares of ₹ 100 each	5,00,000
	12,00,000

The Tribunal approved a scheme of re-organisation to take effect on 1.4.2016 whereby :

(i) The Preference Shares are to be written down to ₹ 75 each and Equity Shares to ₹ 1 each.

(ii) Preference Dividend were in arrear for 4 years. It was decided to waive 3/4th and Equity Shares of ₹ 1 each to be allotted for the remaining quarter.

(ii) Accrued interest on debentures are to be paid in cash.

(iv) Invesments are to be sold for ₹ 1,00,000.

(v) Amount of ₹ 9,000 is to be provided for bad debts.

(vi) Patents, Goodwill and Deferred Advertising are to be written off.

(vii) Plant is valued at ₹ 78,000.

You are asked to show Journal Entries of the above transactions in the books of the company.

Solution **In the books of Eknath & Co. Ltd.**

Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2016 Jan. 1	10% Cumulative Preference Share Capital (₹ 100) A/c Dr.		7,00,000	
	To 10% Cumulative Preference Share Capital (₹ 75) A/c			3,75,000
	To Capital Reduction A/c			3,25,000
	(Being 5,000 cumulative preference shares of ₹ 100 each fully paid reduced to cumulative preference shares of ₹ 75 each fully paid as per Special Resolution No. ... dated ... confirmed by the Tribunal vide Order No. ...)			
	Equity Share Capital (₹ 10) A/c Dr.		7,00,000	
	To Equity Share Capital (₹ 1)			70,000
	To Capital Reduction A/c			6,30,000
	(Being 70,000 equity shares of ₹ 10 each fully paid reduced to equity shares of ₹ 1 each fully paid as per Special Resolution No. ... dated ... confirmed by the Tribunal vide Order No. ...)			
	Accrued Interest A/c Dr.		24,000	
	To Bank A/c			24,000
	(Being the accrued interest on debentures paid in cash)			
	Capital Reduction A/c (1/4 of ₹ 2,00,000)		50,000	
	To Equity Share Capital A/c			50,000
	(Being 1/4th of arrear preference dividend paid by issue of equity shares of ₹ 1 each fully paid)			
	Bank A/c Dr.		1,00,000	
	To Investments a/c			60,000
	To Capital Reduction A/c			40,000
	(Being the sale of investments. The profit on sale transferred to Capital Reduction Account)			
	Capital Reduction A/c Dr.		7,45,000	
	To Profit and Loss A/c			5,50,000
	To Goodwill A/c			1,22,000
	To Patent A/c			38,000
	To Plant A/c			22,000
	To Provision for Bad Debts A/c			9,000
	To Capital Reserve A/c (Note 1)			4,000
	(Being the balance of Capital Reduction Account used for writing off Profit and Loss (Dr.) balance, goodwill, patent, plant etc. The balance amount transferred to Capital Reserve)			

Working Note :

Dr. (1) Capital Reduction Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2016	To Equity Share Capital A/c	50,000	2016	By 10% Cumulative Preference Share Capital A/c	1,25,000
Apr. 1	To Profit and Loss A/c	5,50,000	Apr. 1	By Equity Share Capital A/c	6,30,000
	To Goodwill A/c	1,22,000		By Bank A/c	40,000
	To Patent A/c	38,000			
	To Plant A/c	22,000			
	To Profit and Loss A/c	9,000			
	To Capital Reserve A/c (Balancing figure)	4,000			
		7,95,000			7,95,000

Illustration 7

Following a series of trading losses, Sputnik Ltd. resolved to reduce its capital to 50,000 fully paid ₹ 5 shares and to eliminate its Securities Premium Account. The company's Balance Sheet prior to implementation of the Scheme was :

Balance Sheet of Sputnik Ltd. as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 50,000 Equity Shares of ₹ 10 each fully paid		5,00,000
(b) Reserves and Surplus :		
Securities Premium		50,000
Profit and Loss Account		(50,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		62,000
TOTAL		5,62,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		1,62,000
Plant and Machinery		2,07,000
(i) Intangible Assets		
Goodwill		1,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		92,000
(c) Trade Receivables — Sundry Debtors		74,000
(d) Cash and Cash Equivalents — Bank Overdraft		(73,000)
TOTAL		5,62,000

It was resolved to apply the sum available under the scheme :

(i) to write-off the Goodwill Account,

(ii) to write-off the debit balance of the Profit and Loss Account,

(iii) to reduce the book values of the assets by the following amounts:

(a) Land and Buildings — ₹ 42,000;

(b) Plant and Machinery — ₹ 67,000;

(c) Stock — ₹ 33,600,

(iv) to provide a Bad Debt Provision of 10% of the book value of debtors.

Show by Journal Entries, the accounting adjustment required to give effect to the Scheme and prepare the revised Balance Sheet after its implementation.

Solution

In the books of Sputnik Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Equity Share Capital (₹ 10) A/c	Dr.		5,00,000	
	To Equity Share Capital (₹ 5) A/c				2,50,000
	To Capital Reduction A/c				2,50,000
	(Being 50,000 Equity Shares of ₹ 10 each fully paid reduced to Equity Shares of ₹ 5 each fully paid as per Special Resolution no. ... dt. ... confirmed by the Tribunal *vide* order dt. ...)				
	Securities Premium A/c	Dr.		50,000	
	To Capital Reduction A/c				50,000
	(Being the transfer of Securities Premium A/c to Capital Reduction A/c as per Scheme of reconstruction)				
	Capital Reduction A/c	Dr.		3,00,000	
	To Goodwill A/c				1,00,000
	To Profit and Loss A/c				50,000
	To Land and Building A/c				42,000
	To Plant and Machinery A/c				67,000
	To Inventory A/c				33,600
	To Provision for Bad Debt A/c (10% of ₹ 74,000)				7,400
	(Being the balance of Capital Reduction Account used for writing off Goodwill and P/L A/c debit balance, for writing down the value of Plant and Machinery, Land and Building, Inventories and Debtors as per Scheme of reconstruction)				

Sputnik Ltd (and Reduced)
Balance Sheet as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,50,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(2)	62,000
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		3,12,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,60,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	58,400
(c) Trade Receivables	(7)	66,600
(d) Cash and Cash Equivalents		(73,000)
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		3,12,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
50,000 Equity Shares of ₹ 5 each fully paid	2,50,000
(2) Trade Payables	
Creditors	62,000
(3) Other Current Liability	Nil

(4) Fixed Assets

Particulars		₹
Tangible Assets :		
Land and Building	1,62,000	
Less: Written off as per Scheme	42,000	1,20,000
Plant and Machinery	2,07,000	
Less: Written off as per Scheme	67,000	1,40,000
		2,60,000
Intangible Assets :		
Goodwill		1,00,000
Less: Written off as per Scheme		1,00,000
		Nil
(6) Inventories		
Balance as per Balance Sheet		92,000
Less: Written off as per Scheme		33,600
		58,400
(7) Trade Receivables		
Debtors		74,000
Less: Written off as per Scheme		7,400
		66,600

Illustration 8

The following is the Balance Sheet of Weak Ltd. as on 31.3.2016 :

Balance Sheet of Weak Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,50,000
(b) Reserves and Surplus — Profit and Loss Account		(1,95,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 8% Debentures		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Trade Creditors		3,30,000
(c) Other current liabilities — Creditors for expenses		20,000
TOTAL		5,05,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Building		2,00,000
Machinery		1,30,000
(ii) Intangible Assets :		
Patent		40,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		80,000
(c) Trade Receivables — Debtors		55,000
(d) Cash and Cash Equivalents		—
TOTAL		5,05,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000
500, 10% Non-Cumulative Preference Shares of ₹ 100 each	50,000
	2,50,000

With a view to reconstruct the company, it is proposed to :

(a) reduce — (i) equity shares by ₹ 9 each;
(ii) 10% preference shares by ₹ 40 each;
(iii) 8% debentures by 10%;
(iv) trade creditors claim by one-third;
(v) machinery to ₹ 70,000;
(vi) inventories by ₹ 10,000.

(b) provide ₹ 15,000 for doubtful debts.

(c) write off all the intangible assets.

(d) raise the rate of preference dividend to 13% and the rate of debenture interest to 13.5%.

Assuming that the aforesaid proposals are duly approved and sanctioned, pass the journal entries to give effect to the above, and show the Company's Post-construction Balance Sheet.

Solution

In the books of Weak Ltd
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Equity Share Capital (₹ 10) A/c	Dr.		2,00,000	
March 31	To Equity Share Capital (Re 1) A/c				20,000
	To Capital Reduction A/c				1,80,000
	(Being 20,000 equity shares of ₹ 10 each fully paid reduced to 20,000 equity shares of Re 1 each fully paid as per Special Resolution No. . . . dt ... confirmed by the Tribunal vide Order dtd ...)				
	10% Non-cumulative Preference Share Capital (₹ 100) A/c	Dr.		50,000	
	To 13% Non-cumulative Preference Share Capital (₹ 60) A/c				30,000
	To Capital Reduction A/c				20,000
	(Being 500, 10% Non-cumulative Preference Shares of ₹ 100 each converted into 500, 13% Non-cumulative Preference Shares of ₹ 60 each fully paid up as per Special Resolution No. . . . dated . . . confirmed by the Tribunal vide Order dated . . .)				
	8% Debentures (₹ 100) A/c	Dr.		1,00,000	
	To 13.5% Debentures (₹ 90) A/c				90,000
	To Capital Reduction A/c				10,000
	(Being 1,000, 8% Debentures of ₹ 100 each converted into 13.5% debentures of ₹ 90 each as per scheme of reconstruction)				
	Trade Creditors A/c	Dr.		1,10,000	
	To Capital Reduction A/c				1,10,000
	(Being the amount sacrificed by the trade creditors as per the scheme of reconstruction)				
	Capital Reduction A/c	Dr.		3,20,000	
	To Machinery A/c (₹ 1,30,000 – ₹ 70,000)				60,000
	To Inventories A/c				10,000
	To Provision for Doubtful Debts A/c				15,000
	To Profit and Loss A/c				1,95,000
	To Patents A/c (Note 1)				40,000
	(Being the balance of Capital Reduction Account used for writing down the value of machinery, inventories, debtors, and for writing off the debit balance of Profit and Loss Account, preliminary expenses and patents as per scheme of reconstruction)				

Weak Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	50,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	90,000
(b) Deferred Tax Liabilities (Net)		—
(c) Other Long-term Liabilities		—
(d) Long-term Provisions		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	2,20,000
(c) Other Current Liabilities	(3)	20,000
(d) Short-term Provisions		—
TOTAL		3,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,70,000
(ii) Intangible Assets	(5)	Nil
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments		—
(c) Deferred Tax Assets (Net)		—
(d) Long-term Loans and Advances		—
(e) Other Non-current Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	70,000
(c) Trade Receivables	(8)	40,000
(d) Cash and Cash Equivalents		—
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		3,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
20,000 Equity Shares of ₹ 1 each fully paid	20,000
500, 13% Non-Cumulative Preference Shares of ₹ 60 each fully paid	30,000
	50,000

(2) Long-term Borrowings

Particulars	₹
Secured	
13.5% Debentures	90,000

(5) Fixed Assets

Particulars		₹
Tangible Assets :		
Building		2,00,000
Machinery	1,30,000	
Less: Written off as per Scheme	60,000	70,000
		2,70,000
Intangible Assets :		
Patent		40,000
Less: Written off as per Scheme		40,000
		Nil

		(7) Inventories	80,000
(3) Trade Payables		Less: Written off as per Scheme	10,000
Trade Creditors	2,20,000		70,000
(4) Other Current Liabilities		**(8) Trade Receivables**	
Creditors for Expenses	20,000	Debtors	55,000
		Less: Provision for Doubtful Debts	15,000
			40,000

Working Note :

(1) Patents are intangible assets. Therefore, these are to be written-off.

Illustration 9

The following is the Balance Sheet of Ference and Coli Ltd. as on December 31, 2015 :

Balance of Ference and Coli Ltd. Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,00,000
(b) Reserves and Surplus	(2)	(51,500)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 11% Debentures of ₹ 100 each		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors		1,37,250
TOTAL		8,85,750
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant		2,33,500
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		4,06,200
(c) Trade Receivables — Debtors		2,33,750
(d) Cash and Cash Equivalents		12,300
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		8,85,750

Notes to Accounts :

(1) Share Capital

Particulars	
Issued, Subscribed and Paid-up Capital :	
50,000 Equity Shares of ₹ 10 each fully paid	5,00,000
2,000, 10% Preference Shares of ₹ 100 each	2,00,000
	7,00,000
(2) Reserve and Surplus	
Reserve	2,26,750
Profit and Loss A/c Balance	(2,78,250)
	(51,500)

The company after the approval of the Tribunal, puts the following scheme of reconstruction :

(a) Each existing Preference Share is to be reduced to ₹ 35, of which ₹ 20 will be represented by new 12% Preference Shares and ₹ 15 by new Equity Shares;

(b) Each Debentures of ₹ 100 is to be exchanged for ₹ 50 of new 13% Debenture, one new 12% Preference Share of ₹ 25 each and four new Equity Shares of ₹ 2.50 each;

(c) Each existing Equity Share is to be reduced to ₹ 2.50.

The reduction of capital and reserves are utilised for writing off losses, 50% Stock and Debtors and balance, if any, is used for writing-down Plant.

Show the necessary Journal Entries and draw up the the revised Balance Sheet.

Solution

In the books of Ference and Coli Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2015	10% Preference Share Capital (₹ 100) A/c Dr.		2,00,000	
Dec 31	To 12% Preference Share Capital (₹ 20) A/c			40,000
	To Equity Share Capital (₹ 2.50) A/c			30,000
	To Capital Reduction A/c			1,30,000
	(Being 2,000, 10% Pref. Sh. of ₹ 100 each fully paid reduced to 2,000, 12% Pref. Sh. of ₹ 20 each, ₹ 20 paid up and 12,000 Equity Sh. of ₹ 2.50 each fully paid as per Special Resolution no. ... dated .... confirmed by the Tribunal *vide* **order dated ....)**			
	11% Debentures (₹ 100) A/c Dr.		1,00,000	
	To 13% Debenture (₹ 50) A/c			50,000
	To 12% Preference Share Capital (₹ 25) A/c			25,000
	To Equity Share Capital (₹ 2.50) A/c			10,000
	To Capital Reduction A/c			15,000
	(Being 1,000, 11% Debentures of ₹ 100 each fully paid reduced to 1,000, 13% Debentures of ₹ 50 each fully paid 1,000, 12% Pref. Sh. of ₹ 25 each fully paid and 4,000 Equity Sh. of ₹ 2.50 each fully paid as per Special Resolution no. .... dated ....confirmed by the Tribunal *vide* order dated.....)			
	Equity Share Capital (₹ 10) A/c Dr.		5,00,000	
	To Equity Share Capital (₹ 2.50) A/c			1,25,000
	To Capital Reduction A/c			3,75,000
	(Being 50,000 Equity Shares of ₹ 10 each fully paid reduced to 50,000 Equity Shares of ₹ 2.50 each fully paid as per Special Resolution no. ... dated... confirmed by the Tribunal *vide* order dt. ....)			
	Reserve A/c Dr.		2,26,750	
	To Capital Reduction A/c			2,26,750
	(Being the transfer of Reserve to Capital Reduction A/c)			
	Capital Reduction A/c Dr.		7,46,750	
	To Profit and Loss A/c			2,78,250
	To Provision for Doubtful Debts A/c			1,16,875
	To Stock A/c			2,03,100
	To Plant A/c			1,48,525
	(Being the balance of Capital Reduction Account used for writing off Profit and Loss A/c debit balance, and writing down the value of debtors, Stock and Fixed assets as per scheme of reconstruction)			

Ference & Coli Ltd (and Reduced)
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,30,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	50,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	1,37,250
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		4,17,250
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	84,975
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	2,03,100
(c) Trade Receivables	(6)	1,16,875
(d) Cash and Cash Equivalents	(7)	12,300
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		4,17,250

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ 2.50 each	?
... Preference Shares of ₹ 25 each	?
	?
Issued and Subscribed Capital :	
66,000 Equity Shares of ₹ 2.50 each fully paid	1,65,000
1,000, 12% Preference Shares of ₹ 25 each	25,000
2,000, 12% Pref. Shares of ₹ 25 each, ₹ 20 paid up	40,000
	2,30,000

(2) Long-term Borrowings

Secured	
1,000, 13% Debentures of ₹ 50 each fully paid	50,000

(3) Trade Payables

Creditors	1,37,250

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant	2,33,500
Less: Written off as per Scheme	1,48,525
	84,975

(5) Inventories

Stock	4,06,200
Less: Written off as per Scheme	2,03,100
	2,03,100

(6) Trade Receivables

Debtors	2,33,750
Less: Provision for Doubtful Debts	1,16,875
	1,16,875

(7) Cash and Cash Equivalents

Cash	12,300

Illustration 10

Green Limited had decided to reconstruct the Balance Sheet since it had accumulated huge losses. The following is the Balance Sheet of the company on 31.3.2016 before reconstruction:

Balance Sheet of Green Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	65,00,000
(b) Reserves and Surplus — Profit and Loss Account		(20,00,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—

(3) Non-current Liabilities :		
(a) Long-term borrowings	(2)	15,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		5,00,000
TOTAL		65,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Building		10,00,000
Plant		10,00,000
Computers		25,00,000
(ii) Intangible Assets		
Goodwill		20,00,000
(2) Current Assets :		—
TOTAL		65,00,000

Notes to Accounts :

(1) Share Capital

Particulars	
Authorised Capital :	
1,50,000 Equity Shares of ₹ 50 each	75,00,000
Issued, Subscribed and Paid-up Capital :	
50,000 Equity Shares of ₹ 50 each fully paid	25,00,000
1,00,000 Equity Shares of ₹ 50 each, ₹ 40 per share paid-up	40,00,000
	65,00,000
(2) Long-term Borrowings	
12% First Debentures	5,00,000
12% Second Debentures	10,00,000
	15,00,000

The following is the interest of Mr X and Mr Y in Green Limited :

Particulars	Mr. X (₹)	Mr. Y (₹)
12% First Debentures	3,00,000	2,00,000
12% Second Debentures	7,00,000	3,00,000
Sundry Creditors	2,00,000	1,00,000
	12,00,000	6,00,000
Fully paid-up ₹ 50 Shares	3,00,000	2,00,000
Partly paid-up Shares (₹ 40 paid-up)	5,00,000	5,00,000

The following scheme of reconstruction is approved by all parties interested and also by the Tribunal :

(a) Uncalled capital is to be called up in full and such shares and the other fully paid-up shares be converted into equity shares of ₹ 20 each.

(b) Mr X is to cancel ₹ 7,00,000 of his total debt (other than share amount) and to pay ₹ 2 lakhs to the company and to receive new 14% First Debentures for the balance amount.

(c) Mr Y is to cancel ₹ 3,00,000 of his total debt (other than equity shares) and to accept new 14% First Debentures for the balance.

(d) The amount thus surrendered available by the scheme shall be utilised in writing off Goodwill, Profit and Loss Account (Loss) and the balance to write off the value of computers.

You are required to draw the journal entries to record the same and also show the Balance Sheet of the reconstructed company.

[C.A. (Inter) — Adapted]

Solution

In the books of Green Ltd
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 March 31	Equity Share Final Call A/c	Dr.		10,00,000	
	To Equity Share Capital A/c				10,00,000
	(Being final call money due on 1,00,000 shares @ ₹ 10 each as per Board's Resolution No. . . . dated . . .)				
	Bank A/c	Dr.		10,00,000	
	To Equity Share Final Call A/c				10,00,000
	(Being final call money received on 1,00,000 shares @ ₹ 10 each)				
	Equity Share Capital (₹ 50) A/c	Dr.		75,00,000	
	To Equity Share Capital (₹ 20) A/c				30,00,000
	To Capital Reduction A/c				45,00,000
	(Being 1,50,000 equity shares of ₹ 50 each fully paid reduced to equity shares of ₹ 20 each fully paid as per Special Resolution No. . . . dated . . . confirmed by the Tribunal vide Order dated ...)				
	12% First Debentures A/c	Dr.		3,00,000	
	12% Second Debentures A/c	Dr.		7,00,000	
	Sundry Creditors A/c	Dr.		2,00,000	
	To X A/c				12,00,000
	(Being total amount due to X, transferred to his account)				
	Bank A/c	Dr.		2,00,000	
	To X A/c				2,00,000
	(Being the amount received from X under the scheme of reconstruction)				
	X A/c	Dr.		14,00,000	
	To 14% First Debentures A/c				7,00,000
	To Capital Reduction A/c				7,00,000
	(Being the cancellation of ₹ 7,00,000 out of total debts due to X and issue of 14% first debentures to X for the balance amount of his claim)				
	12% First Debentures A/c	Dr.		2,00,000	
	12% Second Debentures A/c	Dr.		3,00,000	
	Sundry Creditors A/c	Dr.		1,00,000	
	To Y A/c				6,00,000
	(Being the total amount due to Y transferred to his account)				
	Y A/c	Dr.		6,00,000	
	To 14% First Debentures A/c				3,00,000
	To Capital Reduction A/c				3,00,000
	(Being the cancellation of ₹ 3,00,000 out of total debts due to Y and issue of 14% first debentures to Y for the balance amount of his claim)				
	Capital Reduction A/c	Dr.		55,00,000	
	To Goodwill A/c				20,00,000
	To Profit and Loss A/c				20,00,000
	To Computers A/c (Note 1)				15,00,000
	(Being the balance of Capital Reduction Account used for writing off Goodwill Account, Profit and Loss Account and Computers Account as per scheme of reconstruction)				

Green Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	30,00,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	10,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	2,00,000
TOTAL		42,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	30,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents	(5)	12,00,000
TOTAL		42,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
Issued and Subscribed Capital :	
1,50,000 Equity Shares of ₹ 20 each fully paid	30,00,000

(2) Long-term Borrowings

Secured	
14% First Debentures	10,00,000

(3) Trade Payables

Sundry Creditors	2,00,000

(4) Fixed Assets

Particulars		₹
Tangible Assets :		
Building		10,00,000
Plant		10,00,000
Computers	25,00,000	
Less: Written off as per Scheme	15,00,000	10,00,000
		30,00,000

(5) Cash and Cash Equivalents

Cash at Bank	12,00,000

Working Note :

Dr. **(1) Capital Reduction Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Goodwill A/c	20,00,000	2016	By Equity Share Capital A/c	45,00,000
March 31	To Profit and Loss A/c	20,00,000	March 31	By X A/c	7,00,000
	To Computers A/c (Balancing figure)	15,00,000		By Y A/c	3,.00,000
		55,00,000			55,00,000

Illustration 11

Following is the Balance Sheet of W Ltd as on 31st March, 2016 :

Balance Sheet of W. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	13,00,000
(b) Reserves and Surplus — Profit and Loss Account		(2,04,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 11% Debentures		3,00,000

(4) Current Liabilities :		
(a) Short-term Borrowings — Loans from Bank (including interest)		86,400
(b) Trade Payables — Creditors		54,500
(c) Other current liabilities — Interest outstanding on Debentures		33,000
TOTAL		15,69,900
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Machinery		8,70,000
Furniture		1,00,000
(ii) Intangible Assets :		
Patent and Copyrights		40,000
(b) Non-current investments (Market Value ₹ 27,500)		32,500
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		3,00,000
(c) Trade Receivables — Debtors		2,19,500
(d) Cash and Cash Equivalents		7,900
TOTAL		15,69,900

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000
3,000, 12% Preference Shares of ₹ 100 each fully paid	3,00,000
	13,00,000

Note : Preference dividend is in arrear for two years.

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

(i) The existing equity shares are converted into equal number of fully paid equity shares of ₹ 7 each. The equity shareholders also agree to take up 50,000 new equity shares of ₹ 7 each, the total amount being paid by them immediately.

(ii) The preference shareholders agree to forego arrears of dividend and accept 85% of their capital amount by way of redemption of all the preference shares.

(iii) The debentureholders agree to give up their claim to outstanding interest in consideration of the rate of interest on debentures being enhanced to 13.5%.

(iv) Bank agrees to waive its claim to oustanding interest amounting to ₹ 6,400 provided the balance of loan of ₹ 80,000 to be paid off forthwith.

(v) Investments are to appear at market value.

(vi) Patents and copyrights are to be written off completely.

(vii) Machinery is to be written down to the extent possible after writing off all other losses.

Pass journal entries necessary to implement the above-mentioned scheme and prepare the Balance Sheet of the company in the prescribed form immediately after the implementation of the scheme.

[C.S. (Inter) — Adapted]

Solution

In the books of W Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Equity Share Capital (₹ 10) A/c	Dr.		10,00,000	
March 31	To Equity Share Capital (₹ 7) A/c				7,00,000
	To Capital Reduction A/c				3,00,000
	(Being 1,00,000 equity shares of ₹ 10 each fully paid up reduced to equity shares of ₹ 7 each fully paid as per special resolution No. . . . dated ... confirmed by the Tribunal vide Order dtd . . .)				
	Bank A/c	Dr.		3,50,000	
	To Equity Share Application A/c				3,50,000
	(Being application money received on 50,000 equity shares @ ₹ 7 each)				

		Dr. (₹)	Cr. (₹)
Equity Share Application A/c To Equity Share Capital A/c (Being the issue of 50,000 equity shares of ₹ 7 each fully paid as per Board's Resolution No. . . . dated . . .)	Dr.	3,50,000	 3,50,000
12% Preference Share Capital A/c To Preference Shareholders A/c To Capital Reduction A/c (Being the amount payable to preference shareholders equal to 85% of the preference share capital as per scheme of reconstruction)	Dr.	3,00,000	 2,55,000 45,000
Preference Shareholders A/c To Bank A/c (Being the amount paid to preference shareholders in relation to redemption of preference shares)	Dr.	2,55,000	 2,55,000
11% Debentures A/c Interest Outstanding on Debentures A/c To 13.5% Debentures A/c To Capital Reduction A/c (Being 11% debentures of ₹ 3,00,000 converted into 13.5% debentures of ₹ 3,00,000. Interest outstanding on debentures foregone by the debentureholders transferred to Capital Reduction Account as per scheme of reconstruction)	Dr. Dr.	3,00,000 33,000	 3,00,000 33,000
Loan from Bank A/c To Bank A/c To Capital Reduction A/c (Being bank loan repaid to the extent of principal amount. Interest on bank loan foregone by the bank transferred to Capital Reduction Account as per the scheme of reconstruction)	Dr.	86,400	 80,000 6,400
Capital Reduction A/c (Note 1) To Profit and Loss A/c To Patents and Copyrights A/c To Investments A/c To Machinery A/c (Being the balance of Capital Reduction Account used for writing off Profit and Loss Account, patents and copyrights, investments and machinery as per scheme of reconstruction)	Dr.	3,84,400	 2,04,000 40,000 5,000 1,35,400

W Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,50,000
(b) Reserves and Surplus		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	3,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	54,500
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		14,04,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	8,34,600
(ii) Intangible Assets	(5)	Nil

(2) Current Assets :		
(a) Current Investments	(6)	27,500
(b) Inventories	(7)	3,00,000
(c) Trade Receivables	(8)	2,19,500
(d) Cash and Cash Equivalents	(9)	22,900
TOTAL		14,04,500

Notes to Accounts :

(1) Share Capital

Particulars		₹	Particulars	₹
Authorised Capital :			*Intangible Assets*	
... Equity Shares of ₹ ... each		?	Patent and Copyrights	40,000
Issued and Subscribed Capital :			Less: Written off as per Scheme	40,000
1,50,000 Equity Shares of ₹ 7 each fully paid		10,50,000		Nil
(2) Long-term Borrowings			**(6) Investment (Market Value)**	27,500
Secured			**(7) Inventories**	
13.5% Debentures		3,00,000	Stock	3,00,000
(3) Trade Payables			**(8) Trade Receivables**	
Creditors		54,500	Debtors	2,19,500
(4) Fixed Assets			**(9) Cash and Cash Equivalents**	
Tangible Assets :			Cash at Bank (W.N. 2)	22,900
Machine	8,70,000			
Less: Written off as per Scheme	1,35,400	7,34,600		
Furniture		1,00,000		
		8,34,600		

Tutorial Note : Arrear of preference dividend for 2 years has not been provided in the books of account. Therefore, on cancellation of all such dividends, no entry is required.

Working Notes :

Dr. **(1) Capital Reduction Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Profit and Loss A/c	2,04,000	2016	By Equity Share Capital A/c	3,00,000
March 31	To Patents and Copyrights A/c	40,000	March 31	By 12% Preference Share Capital A/c	45,000
	To Investments A/c	5,000		By Interest Outstanding on Debentures A/c	33,000
	To Machinery A/c	1,35,400		By Loan from Bank A/c	6,400
		3,84,400			3,84,400

Dr. **(2) Bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2016	To Balance b/d	7,900	2016	By Preference Shareholders A/c	2,55,000
March 31	To Equity Share Application A/c	3,50,000	March 31	By Loan from Bank A/c	80,000
				By Balance c/d	22,900
		3,57,900			3,57,900

Illustration 12

The following is the Balance Sheet of Tipu Ltd., a company which is incurring losses for the last two years :

Balance Sheet of Tipu Ltd. as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	9,00,000
(b) Reserves and Surplus — Profit and Loss Account		(4,25,000)
— General Reserve		2,50,000

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities : (a) Long-term borrowings — 6% Debentures of ₹ 100 each fully paid		1,00,000
(4) Current Liabilities : (a) Short-term Borrowings (b) Trade Payables — Creditors		— 3,25,000
TOTAL		11,50,000
II. ASSETS		
(1) Non-current Assets : (a) Fixed Assets		6,90,000
(2) Current Assets : (a) Current Investments (b) Inventories — Stock (c) Trade Receivables — Debtors (d) Cash and Cash Equivalents		— 1,95,000 1,05,000 1,60,000
TOTAL		11,50,000

Notes to Accounts :

(1) Share Capital

Particulars	
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
3,000, 10% Preference Shares of ₹ 100 each fully paid	3,00,000
	9,00,000

Note : Preference dividends are in arrear for two years.

The directors decided upon a scheme of reconstruction with a reduction of capital and it is approved on the following terms :

(i) Equity shares to be converted into same number of equity shares of such face value as to reduce the paid-up equity share capital by 30%.

(ii) Preference shares to be converted into same number of preference shares of ₹ 60 each, fully paid-up.

(iii) Balance of general reserve to be utilised in full.

(iv) Debentures to be converted into such number of 8% debentures of ₹ 50 each as to generate the same amount of interest as before.

(v) Fixed assets and stock are to be reduced by ₹ 2,76,000 and ₹ 19,000 respectively.

(vi) Arrears of preference dividend to be written off in full. Balance of Profit and Loss Account also to be written off.

(vii) The following are to be given effect to :
(a) unrecorded debtors ₹ 1,67,000;
(b) unrecorded payment to creditors ₹ 40,000;
(c) reconstruction expenses amounted to ₹ 5,750.

Pass necessary journal entries to give effect to the above scheme.

Solution

In the books of Tipu Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 Dec. 31	Equity Share Capital (₹ 10) A/c Dr.		6,00,000	
	To Equity Share Capital (₹ 7) A/c			4,20,000
	To Capital Reduction A/c			1,80,000
	(Being 60,000 equity shares of ₹ 10 each fully paid converted into 60,000 equity shares of ₹ 7 each fully paid as per Special Resolution No. . . . dated . . . as confirmed by the Tribunal)			
	10% Preference Share Capital (₹ 100) A/c Dr.		3,00,000	
	To 10% Preference Share Capital (₹ 60) A/c			1,80,000
	To Capital Reduction A/c			1,20,000
	(Being 3,000, 10% preference shares of ₹ 100 each fully paid converted into 3,000, 10% preference shares of ₹ 60 each fully paid as per Special Resolution No. . . . dated . . . as confirmed by the Tribunal)			

General Reserve A/c Dr.		2,50,000	
To Capital Reduction A/c			2,50,000
(Being the balance of general reserve transferred to Capital Reduction Account as per reconstruction scheme)			
6% Debentures (₹ 100) A/c Dr.		1,00,000	
To 8% Debentures (₹ 50) A/c			75,000
To Capital Reduction A/c			25,000
(Being 1,000, 6% debentures of ₹ 100 each converted into 1,500, 8% debentures of ₹ 50 each fully paid-up as per Special Resolution No. . . . dated . . . as confirmed by the Tribunal)			
Debtors A/c Dr.		1,67,000	
To Capital Reduction A/c			1,67,000
(Being the amount of unrecorded debtors transferred to Capital Reduction Account)			
Creditors A/c Dr.		40,000	
To Bank A/c			40,000
(Being the amount paid to creditors by cheque which was not recorded by mistake, now rectified)			
Capital Reduction A/c Dr.		5,750	
To Bank A/c			5,750
(Being the payment of reconstruction expenses)			
Capital Reduction A/c Dr.		7,36,250	
To Profit and Loss A/c			4,25,000
To Fixed Assets A/c			2,76,000
To Stock A/c			19,000
To Capital Reserve A/c			16,250
(Being the balance of Capital Reduction Account used for writing-off Profit and Loss Account, fixed assets and stock, and the balance transferred to Capital Reserve Account as per scheme of reconstruction)			

Tutorial Note : (1) Arrear of preference dividend for 2 years has not been provided in the books of account. Therefore, on cancellation of all such dividend, no entry is required.

Working Note :

Dr. **Capital Reduction Account** **Cr.**

Particulars	₹	Particulars	₹
To Bank A/c	5,750	By Equity Share Capital A/c	1,80,000
To Profit and Loss A/c	4,25,000	By 10% Preference Share Capital A/c	1,20,000
To Fixed Assets A/c	2,76,000	By General Reserve A/c	2,50,000
To Stock A/c	19,000	By 6% Debentures A/c	25,000
To Capital Reserve A/c	16,250	By Debtors A/c	1,67,000
	7,42,000		7,42,000

Illustration 13

The following is the Balance Sheet of Downhill Ltd as on 31.12.2015 :

Balance Sheet of Downhill Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 20,000 Equity Shares of ₹ 100 each fully paid		20,00,000
(b) Reserves and Surplus — Profit and Loss		(20,00,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		5,00,000
(a) Long-term borrowings — 12% Debentures		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors		3,00,000
(c) Other current liabilities — Outstanding of Debenture Interest		1,20,000
TOTAL		9,20,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		1,50,000
Plant and Machinery		3,00,000
Furniture		80,000
(i) Intangible Assets — Goodwill		25,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		2,70,000
(c) Trade Receivables — Debtors		60,000
(d) Cash and Cash Equivalents		35,000
TOTAL		9,20,000

The following scheme of reconstruction is executed :

(i) Equity shares are reduced by ₹ 95 per share. They are, then, consolidated into 10,000 equity shares of ₹ 10 each.

(ii) Debentureholders agree to forego outstanding debenture interest. As a compensation, 12% debentures are converted into 14% debentures, the amount remaining ₹ 5,00,000.

(iii) Creditors are given the option to either accept 50% of their claim in cash in full settlement or to convert their claim into equity shares of ₹ 10 each. Creditors for ₹ 2,00,000 opt for shares in satisfaction of their claims.

(iv) To make payment to creditors opting for cash payment and to augment working capital, the company issues 50,000 equity shares of ₹ 10 each at par, the entire amount being payable alongwith applications. The issue was fully subscribed.

(v) Land and buildings are revalued at ₹ 2,00,000 whereas plant and machinery is to be written down to ₹ 2,10,000. A provision amounting to ₹ 5,000 is to be made for doubtful debts.

Pass journal entries and draft the company's Balance Sheet immediately after the reconstruction.

Solution

In the books of Downhill Ltd

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2015 Dec. 31	Equity Share Capital (₹ 100) A/c	Dr.		20,00,000	
	To Equity Share Capital (₹ 10) A/c				1,00,000
	To Capital Reduction A/c				19,00,000
	(Being 20,000 equity shares of ₹ 100 each converted to 10,000 equity shares of ₹ 10 each as per Special Resolution No. . . . dated . . . as confirmed by the Tribunal)				
	Outstanding Debenture Interest A/c	Dr.		1,20,000	
	To Capital Reduction A/c				1,20,000
	(Being outstanding debenture interest foregone by the debentureholders transferred to Capital Reduction Account as per scheme of reconstruction)				
	12% Debentures A/c	Dr.		5,00,000	
	To 14% Debentures A/c				5,00,000
	(Being 5,000, 12% debentures of ₹ 100 each converted into 5,000, 14% debentures of ₹ 100 each as per the scheme of reconstruction)				
	Creditors A/c	Dr.		3,00,000	
	To Equity Share Capital (₹ 10) A/c				2,00,000
	To Cash A/c				50,000
	To Capital Reduction A/c				50,000
	(Being issue of equity shares to creditors to the extent of ₹ 2,00,000. 50% of the balance paid in cash as per the scheme of reconstruction)				
	Bank A/c	Dr.		5,00,000	
	To Equity Share Application A/c				5,00,000
	(Being application money received for 50,000 equity shares @ ₹ 10 each)				
	Equity Share Application A/c	Dr.		5,00,000	
	To Equity Share Capital A/c				5,00,000
	(Being the issue of 50,000 equity shares of ₹ 10 each at par as per Board's Resolution No. . . . dated . . .)				

Land and Building A/c Dr.		50,000	
To Capital Reduction A/c			50,000
(Being the appreciation in the value of land and building transferred to Capital Reduction Account)			
Capital Reduction A/c Dr.		21,20,000	
To Profit and Loss A/c			20,00,000
To Goodwill A/c			25,000
To Provision for Doubtful Debts A/c			5,000
To Plant and Machinery A/c			90,000
(Being the balance of Capital Reduction Account used for writing-off Profit and Loss Account, goodwill, plant and machinery and creating provision for doubtful debts as per scheme of reconstruction)			

Downhill Ltd (and Reduced)
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus		
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	5,00,000
(4) Current Liabilities :		—
TOTAL		13,00,000
II. ASSETS		
(1) Non-current Assets :		—
(a) Fixed Assets		
(i) Tangible Assets	(3)	4,90,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(4)	2,70,000
(c) Trade Receivables	(5)	55,000
(d) Cash and Cash Equivalents	(6)	4,85,000
TOTAL		13,00,000

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
... Equity Shares of ₹ ... each		?
Issued and Subscribed Capital :		
80,000 Equity Shares of ₹ 10 each fully paid (W.N. 3)		8,00,000

(2) Long-term Borrowings

Secured		
5,000, 14% Debentures of ₹ 100 each fully paid		5,00,000

(3) Fixed Assets

Tangible Assets :		
Land and Building	1,50,000	
Add: Appreciation	50,000	2,00,000
Plant and Machinery	3,00,000	
Less: Written off as per Scheme	90,000	2,10,000
Furniture		80,000
		4,90,000

(4) Inventories

Particulars	₹
Stock	2,70,000

(5) Trade Receivables

Debtors	60,000
Less: Provision for Bad Debts	5,000
	55,000

(6) Cash and Cash Equivalents

Bank (W.N. 2)	4,85,000

Working Notes :

Dr. **(1) Capital Reduction Account** **Cr.**

Particulars	₹	Particulars	₹
To Profit and Loss A/c	20,00,000	By Equity Share Capital A/c	19,00,000
To Goodwill A/c	25,000	By Outstanding Debenture Interest A/c	1,20,000
To Provision for Doubtful Debts A/c	5,000	By Creditors A/c	50,000
To Plant and Machinery A/c	90,000	By Land and Building A/c	50,000
	21,20,000		21,20,000

Dr. **(2) Bank Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	35,000	By Creditors A/c	50,000
To Equity Share Application A/c	5,00,000	By Balance c/d	4,85,000
	5,35,000		5,35,000

(3) Total No. of Equity Shares = 10,000 shares (for existing shareholders) + 20,000 (for creditors) + 50,000 (new issue) = 80,000.

Illustration 14

The Balance Sheet of Fortune Ltd. as at 31.12.2015 was as follows:

Balance Sheet of Fortune Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,50,000
(b) Reserves and Surplus	(2)	(2,16,250)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 10% Debentures of ₹ 100 each		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		77,500
(c) Other current liabilities — Accrued Interest on Debentures		15,000
TOTAL		4,26,250
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Building		1,10,000
Plant and Machinery		1,30,000
Furniture and Fixtures		25,000
(ii) Intangible Assets — Patents and Trademarks		40,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock-in-Trade		50,000
(c) Trade Receivables — Sundry Debtors		35,000
(d) Cash and Cash Equivalents	(3)	36,250
TOTAL		4,26,250

Notes to Accounts :

(1) Share Capital

Particulars	
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000
25,000, 10% Preference Shares of ₹ 10 each fully paid	2,50,000
	4,50,000
(2) Reserve and Surplus	
Capital Reserve	12,500
Profit and Loss Account Balance	(2,28,750)
	(2,16,250)
(3) Cash and Cash Equivalents	
Cash in Hand	11,250
Cash at Bank	25,000
	36,250

It is found that the Preference Dividend is in arrear for 3 years. The company prepared the following scheme of reconstruction and it was approved by the Tribunal :

(a) The 10% Preference Shares will be converted into 12% Preference Shares of ₹ 5 each.

(b) Equity Shares will be reduced to ₹ 5 per share, ₹ 3 paid- up. The call was to be made immediately for acquiring cash.

(c) 10% Debentures will be converted into 12% Debentures of ₹ 75 each, the debentureholders agreed to forego 50% of the accrued interest on the stipulation of payment of the balance amount in cash.

(d) Arrear preference dividend was agreed to be cancelled.

(e) Sundry creditors agrees to waive 40% of their claims in consideration of immediate payment of their dues.

(f) The assets were revalued : Building ₹ 1,40,000; Plant and Machinery ₹ 1,20,000; Furniture ₹ 38,000; Stock-in-trade ₹ 50,000; Sundry Debtors ₹ 30,000.

(g) Patents and Trade Marks and other fictitious assets are to be written-off as far as possible.

Draft Journal Entries necessary to give effect to the aforesaid scheme and prepare the Balance Sheet. Detailed workings are to be shown.

Solution

In the books of Fortune Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2015	10% Preference Share Capital (₹ 10) A/c Dr.		2,50,000	
Dec 31	To 12% Preference Share Capital (₹ 5) A/c			1,25,000
	To Capital Reduction A/c			1,25,000
	(Being 25,000, 10% Pref. Shares of ₹. 10 each fully paid converted into 25,000, 12% Pref. Shares of ₹ 5 each fully paid as per Special Resolution no. ... dated.... confirmed by the Tribunal *vide* **order dated......)**			
	Equity Share Capital (₹ 10) A/c Dr.		2,00,000	
	To Equity Share Capital (₹ 5) A/c			60,000
	To Capital Reduction A/c			1,40,000
	(Being 20,000 Equity Shares of ₹ 10 each fully paid reduced to 20,000 Equity Shares of ₹ 5 each, ₹ 3 paid up as per Special Resolution no. ... dated ...... confirmed by the Tribunal *vide* order dated ....)			
	Equity Share Call A/c Dr.		40,000	
	To Equity Share Capital A/c			40,000
	(Being money payable on 20,000 Equity Shares @ ₹ 2 per Share as per Board's Resolution no. ... dated ....)			
	Bank A/c Dr.		40,000	
	To Equity Share Call a/c			40,000
	(Being call money received on 20,000 Shares @ ₹ 2 each)			

10% Debentures (₹ 100) A/c Dr.		1,00,000	
To 12% Debentures (₹ 75) A/c			75,000
To Capital Reduction A/c			25,000
(Being 1,000, 10% Deben. of ₹ 100 each fully paid reduced to 1,000, 12% Debentures of ₹ 75 each fully paid as per Special Resol. no. ... dated ... confirmed by the Tribunal *vide* order dated ...)			
Accrued Interest on Debenture A/c Dr.		15,000	
To Capital Reduction A/c			7,500
To Bank A/c			7,500
(Being 50% of accrued interest transferred to Capital Reduction Account and 50% paid in cash)			
Sundry Creditors A/c Dr.		77,500	
To Capital Reduction A/c			31,000
To Bank A/c			46,500
(Being 40% of creditors' claim transferred to Capital Reduction Account and the balance paid off)			
Building A/c Dr.		30,000	
Furniture and Fixture A/c Dr.		13,000	
To Capital Reduction A/c			43,000
(Being the appreciation in the value of building and furniture transferred to Capital Reduction A/c)			
Capital Reduction A/c Dr.		3,71,500	
To Profit and Loss A/c			2,28,750
To Plant and Machinery A/c			10,000
To Provision for Bad Debts A/c			5,000
To Patents and Trade Marks A/c			40,000
To Capital Reserve A/c			87,750
(Being the balance of Capital Reduction A/c used for writing off Profit and Loss A/c Debit balance, and writing down the value of Plant & Machinery, Debtors and Patents etc. and the balance is transferred to Capital Reserve Account as per scheme of reconstruction)			

Fortune Ltd (and Reduced)
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,25,000
(b) Reserves and Surplus	(2)	1,00,250
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	75,000
(4) Current Liabilities :		
TOTAL		4,00,250
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,98,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		
(c) Trade Receivables	(5)	50,000
(d) Cash and Cash Equivalents	(6)	30,000
(e) Short-term Loans and Advances	(7)	22,250
(f) Other Current Assets		—
TOTAL		4,00,250

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ... each	?
	?
Issued and Subscribed Capital :	
20,000 Equity Shares of ₹ 5 each fully paid	1,00,000
25,000, 12% Preference Shares of ₹ 5 each fully paid	1,25,000
	2,25,000
(2) Reserve and Surplus	
Capital Reserve (₹ 12,500 + 87,750)	1,00,250
(3) Long-term Borrowings	
Secured	
1,000, 12% Debentures of ₹ 75 each fully paid	75,000

(4) Fixed Assets

Particulars		₹
Tangible Assets :		
Building	1,10,000	
Add: Appreciation	30,000	1,40,000
Plant and Machinery	1,30,000	
Less: Written off as per Scheme	10,000	1,20,000
Furniture	25,000	
Add: Appreciation	13,000	38,000
		2,98,000
(5) Inventories		
Stock		50,000
(6) Trade Receivables		
Debtors	35,000	
Less: Provision for Bad Debts	5,000	30,000
(7) Cash and Cash Equivalents		
Bank (W.N. 1)	11,000	
Cash	11,250	22,250

Working Note : (1) Cash at bank = ₹ 25,000 + ₹ 40, 000 – ₹ 7,500 – ₹ 46,500 = ₹ 11, 000.

Illustration 15

The following is the Balance Sheet of B Ltd. on December 31, 2015 :

Balance Sheet of B Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus — Profit and Loss Account		(82,500)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 11% Debentures		1,25,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		22,750
TOTAL		5,65,250
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		2,50,000
Plant and Machinery		1,37,500
Furniture		16,250
(ii) Intangible Assets — Goodwill		75,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		1,31,500
(c) Trade Receivables — Sundry Debtors		23,000
(d) Cash and Cash Equivalents	(2)	(68,000)
TOTAL		5,65,250

Notes to Accounts :

(1) Share Capital

Particulars	
Issued, Subscribed and Paid-up Capital :	
30,000 Equity Shares of ₹ 10 each fully paid	3,00,000
2,000, 12% Preference Shares of ₹ 100 each fully paid	2,00,000
	5,00,000
(3) Cash and Cash Equivalents	
Cash in Hand	375
Bank Overdraft	(68,375)
	68,000

The Preference Dividends are in arrear for 5 years and the company is handicapped by the antiquated nature of Plant. According to expert opinion, substantial profits can be earned if new capital are available and modern Plants are acquired.

A capital reduction scheme is submitted as follows:

(i) Equity shares to be reduced to ₹ 5 each.

(ii) All arrears of preference dividends to be cancelled.

(iii) Each Preference Share to be reduced to ₹ 75 and then exchanged for one new 12% Preference Share of ₹ 50 each and five Equity Shares of ₹ 5 each.

(iv) The debit balance of Profit and Loss Account to be written-off. Plant and Machinery to be written-down by ₹ 47,500 and Goodwill is to be reduced as much as possible.

(v) The Debentures are to be redeemed at 5% premium. Holders being given the option to subscribe at par for new 12% Debentures.

Approval of the Tribunal is obtained. 1,00,000 new Equity Shares are issued at par (sufficient new Equity Shares are created by increasing the Authorised Share Capital) payable in full on application. The whole issue is underwritten for a commission of 2% and is fully taken up. Holders of old Debentures to the extent of ₹ 50,000 exercised their option and subscribed for the new Debentures. Expenses in connection with the scheme amounted to ₹ 3,375.

Show the Journal Entries necessary to record the Reduction Scheme and set out the new Balance Sheet of the company.

Solution

In the books of B Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2015 Dec 31	Equity Share Capital (₹ 10) A/c	Dr.		3,00,000	
	To Equity Share Capital (₹ 5) A/c				1,50,000
	To Capital Reduction A/c				1,50,000
	(Being 30,000 Equity Shares of ₹ 10 each fully paid reduced to 30,000 Equity Shares of ₹ 5 each fully paid as per Special Resolution no. ... dtd. ... confirmed by the Tribunal vide order dtd. ...)				
	12% Preference Share Capital (₹ 100) A/c	Dr.		2,00,000	
	To 12% New Preference Share Capital (₹ 50) A/c				1,00,000
	To Equity Share Capital (₹ 5) A/c				50,000
	To Capital Reduction A/c				50,000
	(Being 2,000, 12% Preference Shares of ₹ 100 each reduced to 2,000, 12% new Preference Shares of ₹ 50 each and 10,000 Equity Shares of ₹ 5 each fully paid as per Special Resolution no. ... dated .... confirmed by the Tribunal *vide* **order dated ....)**				
	Bank A/c	Dr.		5,00,000	
	To Equity Share Application A/c				5,00,000
	(Being application money received for 1,00,000 shares @ ₹ 5 each)				
	Equity Share Application A/c	Dr.		5,00,000	
	To Equity Share Capital A/c				5,00,000
	(Being issue of 1,00,000 Equity Sh. of ₹ 5 each fully paid as per Board's Resolution no.... dtd. ...)				
	11% Debenture A/c	Dr.		1,25,000	
	Premium on Redemption of Debenture A/c	Dr.		6,250	
	To Debentureholders A/c				1,31,250
	(Being the amount payable on Redemption of debenture transferred to Debentureholders A/c)				

Capital Reduction A/c Dr. To Premium on Redemption of Debenture A/c (Being the Premium payable on redemption transferred to Capital Reduction A/c)		6,250	 6,250
Debentureholders A/c Dr. To Bank A/c To 12% New Debenture A/c (Being the issue of 12% new Debentures to the holders of old Debentures of ₹ 50,000 who exercised their option and paid others in cash)		1,31,.250	 78,750 52,500
Capital Reduction A/c Dr. To Bank A/c (Being the expenses incurred in connection with the Scheme of reconstruction)		3,375	 3,375
Underwriting Commission A/c Dr. To Bank A/c (Being the payment of underwriting commision for issue of Shares @ 2% on ₹ 5,00,000)		10,000	 10,000
Capital Reduction A/c Dr. To Profit and Loss A/c To Plant and Machinery a/c To Goodwill A/c (Being the balance of Capital Reduction Account used for writing off Profit and Loss A/c debit balance and for writing down the value of Plant and machinery and Goodwill as per scheme of reconstruction)		1,90,375	 82,500 47,500 60,375

B Ltd (and Reduced)
Balance Sheet as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus (Underwriting Commission)		(10,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	52,500
(4) Current Liabilities :		
(a) Short-term Borrowings		—
TOTAL		8,65,250
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	3,56,250
(ii) Intangible Assets	(5)	14,625
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,31,500
(c) Trade Receivables	(7)	23,000
(d) Cash and Cash Equivalents	(8)	3,39,875
TOTAL		8,65,250

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?

(5) Intangible Assets

Particulars	₹
Goodwill	75,000
Less: Written off as per Scheme	60,375
	14,625

Issued and Subscribed Capital :			**(6) Inventories**	
1,40,000 Equity Shares of ₹ 5 each fully paid		7,00,000	Stock	1,31,500
2,000, 12% Preference Shares of ₹ 50 each		1,00,000	**(7) Trade Receivables**	
		8,00,000	Sundry Debtors	23,000
(2) Long-term Borrowings			**(8) Cash and Cash Equivalents**	
Secured			Cash at Bank (W.N. 1)	3,39,500
12% Debentures		52,500	Cash	375
(3) Trade Payables				3,39,875
Sundry Creditors		22,750		
(4) Fixed Assets				
Tangible				
Land and Building		2,50,000		
Plant and Machinery	1,37,500			
Less: Written off as per Scheme	47,500	90,000		
Furniture		16,250		
		3,56,250		

Tutorial Note :

(1) Arrear preference dividend for 5 years has not been provided in the books of account. Therefore, on cancellation of all such dividend, no entry is required.

Working Note :

(1) Cash in hand and at bank (₹ 5,00,000 – ₹ 10,000 – ₹ 78,750 – ₹ 3,375) = ₹ 4,07,875 less overdraft ₹ 68,375 = ₹ 3,39,500.

Illustration 16

The Balance Sheet of BCR Ltd. as on 31.12.2015 appears as follow:

Balance Sheet of BCR Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	20,00,000
(b) Reserves and Surplus — Profit and Loss Balance		(16,40,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 11% Debentures		5,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Unsecured Loans		5,00,000
(b) Trade Payables		2,60,000
(c) Other current liabilities	(2)	5,00,000
TOTAL		21,20,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	5,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock and Stores		6,00,000
(c) Trade Receivables		14,50,000
(d) Cash and Cash Equivalents — Overdraft		(6,30,000)
(e) Short-term Loans and Advances		—
(f) Other Current Assets		2,00,000
TOTAL		21,20,000

Notes to Accounts :

(1) Share Capital

Particulars	
Issued, Subscribed and Paid-up Capital :	
1,50,000 Equity Shares of ₹ 10 each fully paid	15,00,000
5,000, 11% Preference Shares of ₹ 100 each fully paid	2500,000
	20,00,000
(3) Other Current Liabilities	
Interest accrued and due on Debentures	1,10,000
Interest accrued and due on Unsecured Loans	1,50,000
	2,60,000

A scheme of reconstruction has been agreed amongst the shareholders and the creditors with the following salient features :

(a) Interest due on unsecured loans is waived.

(b) 50% interest due on debentures is waived.

(c) The 11% Preference Shareholders' rights are to be reduced to 50% and converted into 15% Debentures of ₹ 100 each.

(d) Short-term Provisions would be reduced by ₹ 50,000 on account of provision no longer required.

(e) The banks agree to the arrangement and to increase cash credit or overdraft limits by ₹ 1,00,000 upon the shareholders' agreeing to bring in a like amount by way of new equity.

(f) Besides additional subscription as above, the equity shareholders agree to convert the existing equity shares into new ten rupee shares of total value of ₹ 5,00,000.

(g) The debit balance in the Profit and Loss Account is to be written-off totally, ₹ 2,60,000 should be provided for doubtful debts and the value of fixed assets should be increased by ₹ 4,00,000.

Redraft the Balance Sheet of the company based on the above scheme of reconstruction. ***[C.A. (Inter) — Adapted]***

Solution

BCR Ltd (and Reduced)
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,00,000
(b) Reserves and Surplus	(2)	5,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	12,50,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		—
(d) Short-term Provisions (₹ 5,00,000 – 50,000)		4,50,000
TOTAL		23,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		—
(i) Tangible Assets	(5)	9,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		6,00,000
(c) Trade Receivables	(6)	11,90,000
(d) Cash and Cash Equivalents (W.N. 3)		(5,30,000)
(e) Short-term Loans and Advances		—
(f) Other Current Assets		2,00,000
TOTAL		23,60,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
Equity Shares of ₹ ... each	***
Issued and Subscribed Capital :	
60,000 Equity Shares of ₹ 10 each	6,00,000
(4) Other Current Liabilities	
Interest accrued and due to Debentureholders	55,000
(6) Trade Receivables	
Original balance	14,50,000
Less: Provision for Bad Debts	2,60,000
	11,90,000

(2) Reserve and Surplus

Particulars		₹
Capital Reserve (Note 1)		5,000
(3) Long-term Borrowings		
Secured Loans :		
11% Debentures	5,00,000	
15% Debentures	2,50,000	7,50,000
Unsecured Loans		5,00,000
		12,50,000
(5) Fixed Assets		
Tangible Assets :		
Plant and Machinery		20,00,000
Add: Appreciation		4,00,000
		24,00,000
Less: Provision for Depreciation		15,00,000
		9,00,000

Working Notes :

Dr. **(1) Capital Reduction Account** **Cr.**

Particulars	₹	Particulars	₹
To Profit and Loss A/c	16,40,000	By Interest on unsecured Loans A/c	1,50,000
To Provision for Doubtful Debts A/c	2,60,000	By Interest on Debebtures A/c	55,000
To Capital Reserve A/c (Note 2) (Balancing figure)	5,000	By 11% Pref. Share Capital A/c	2,50,000
		By Short-term Provisions	50,000
		By Equity Share Capital	10,00,000
		By Fixed Assets A/c	4,00,000
	19,05,000		19,05,000

(2) Unused balance of Capital Reduction Account should be transferred to Capital Reserve Account.

(3) Cash brought in by shareholders for new shares has been deducted from bank overdraft. Therefore, the balance of ***bank overdraft*** will be ₹ 5,30,000.

Illustration 17

The following was the Balance Sheet of Universal Auto Ltd. as at 31st March, 2016 :

Balance Sheet of Universal Auto Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus — Profit and Loss Account		(61,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 13.5% Debentures		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors (including ₹ 10,000 holding lien on some assets)		50,000
TOTAL		4,89,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		3,80,000
(i) Intangible Assets — Goodwill		1,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		9,000
TOTAL		4,89,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 100 each	10,00,000
Issued and Subscribed Capital :	
3,000 Equity Shares of ₹ 100 each fully paid-up	3,00,000
1,000, 9% Cumulative Preference Shares of ₹ 100 each fully paid up	1,00,000
	4,00,000

The company decided on a scheme for reduction of capital which was duly authorised. The scheme provided as follows:

(1) Two Equity Shares of ₹ 100 each, ₹ 50 paid-up per share to be issued for each Preference Share.
(2) Each existing Equity Share is to reduced to ₹ 50 paid-up, the face value remaining the same at ₹ 100.
(3) 1,000 Equity Shares were taken up by the Directors and paid for by them to the extent of ₹ 50 each.
(4) Arrears of Preference Dividend for the last four years to be cancelled.
(5) Debentureholders to receive 800 Equity Shares of ₹ 100 each credited as fully paid-up.
(6) Unsecured creditors to be paid immediately to the extent of 10% of their claims and they accepted a remission of 20% of their claims.
(7) The amount available as a result of the scheme to be used to write-off the debit balance in the Profit and Loss Account, to write-down Fixed Assets by ₹ 10,000 and to adjust Goodwill.

You are required to give Journal Entries to record the above and give the Balance Sheet after the reconstruction is effected.

Solution

In the books of Universal Auto Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 March 31	9% Cum. Preference Share Capital A/c Dr.		1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Being the issue of two Equity Shares of ₹ 100 each, ₹ 80 paid up, for each Cumulative Preference Shares of ₹ 100 each as per Reconstruction Scheme dated ....)			
	Equity Share Capital A/c Dr.		1,50,000	
	To Capital Reduction A/c			1,50,000
	(Being existing Equity Shares of ₹ 100 each reduced to Equity Shares of ₹ 50 paid up, face value remaining the same at ₹ 100 each as per Reconstruction Scheme dated .....)			
	Bank A/c Dr.		50,000	
	To Equity Share Capital A/c			50,000
	(Being the issue of 1,000 Equity Shares to Directors and paid for by them to the extent of ₹ 50 each as per Reconstruction Scheme dated .....)			
	13.5% Debentures A/c Dr.		1,00,000	
	To Equity Share Capital A/c			80,000
	To Capital Reduction A/c			20,000
	(Being the issue of 800 Equity Shares of ₹ 100 each fully paid to Debentureholders in full satisfaction of their claim as per Reconstruction Scheme dated .....)			

Sundry Creditors A/c (Note 1) Dr.		12,000	
To Bank A/c			4,000
To Capital Reduction A/c			8,000
(Being the unsecured Creditors paid to the extent of 10% of their claims, who agreed to sacrifice 20% of their claims as per Reconstruction Scheme dated .....)			
Capital Reduction A/c Dr.		1,78,000	
To Profit and Loss A/c			61,000
To Fixed Assets A/c			10,000
To Goodwill A/c			1,00,000
To Capital Reserve A/c			7,000
(Being the balance of Capital Reduction A/c utilised for writing off the debit balance of Profit and Loss A/c; and for writing down the value of Fixed Assets and Goodwill and the balance is transferred to Capital Reserve Account as per scheme of reconstruction)			

Universal Auto Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,80,000
(b) Reserves and Surplus	(2)	7,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables (including ₹ 10,000 holding lien on some assets)		38,000
TOTAL		4,25,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	3,70,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		—
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		55,000
TOTAL		4,25,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 100 each	10,00,000
Issued and Subscribed Capital :	
6,000 Equity Shares of ₹ 100 each, ₹ 50 each paid-up	3,00,000
800 Equity Shares of ₹ 100 each fully paid-up	80,000
	3,80,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve (Note 1)	7,000

(3) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	3,80,000
Less: Written-off as per scheme	10,000
	3,70,000

Working Notes :

(1) Unsecured creditors = ₹ 50,000 – ₹ 10,000 = ₹ 40,000. 10% of ₹ 40,000, i.e., ₹ 4,000 is to be paid in cash and 20% of ₹ 40,000, i.e., ₹ 8,000 is to be transferred to Capital Reduction Account.

(2) Closing cash = ₹ 9,000 + ₹ 50,000 – ₹ 4,000 = ₹ 55,000.

Illustration 18

The summarized assets and liabilities position of Hopeful Ltd. as on 1.4.2016 was as under:

Balance Sheet of Hopeful Ltd. as at 1st April, 2016.

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus — Profit and Loss Account		(1,42,800)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — Unsecured Loans		80,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Trade Creditors		48,000
TOTAL		4,85,200
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and building		1,60,000
Plant and Machinery		1,20,000
(ii) Intangible Assets — Goodwill		20,000
(b) Non-current Investment		24,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		54,000
(c) Trade Receivables — Debtors		1,18,000
(d) Cash and Cash Equivalents	(2)	(10,800)
TOTAL		4,85,200

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
80,000 Equity Shares of ₹ 10 each	8,00,000
2,000, 9% Preference Shares of ₹ 100 each	2,00,000
	10,00,000
Issued, Subscribed and Paid-up Capital :	
40,000 Equity Shares of ₹ 10 each, ₹ 7.50 paid per share	3,00,000
2,000, 9% Preference Shares of ₹ 100 each fully paid	2,00,000
	5,00,000
(2) Cash and Cash Equivalents	
Cash in Hand	6,000
Bank Overdraft	(16,800)
	(10,800)

Notes : (i) Dividend on preference shares has not been declared for 2 years.
(ii) No provision has been made for sales tax liability of ₹ 9,600.

The following scheme of reconstruction has been approved by the Tribunal :

(i) Uncalled capital is to be called up in full and Equity Shares are to be reduced to ₹ 5 per share.
(ii) Sales tax liability of ₹ 9,000 is to be paid immediately.
(iii) Land and Building are to be shown in Balance Sheet at full market value of ₹ 2,20,000. Goodwill is to be written-off.
(iv) Trade Creditors have consented for 25% of remission of liability on condition that 25% of net liability after remission is paid forthwith and the balance is paid within one year.
(v) Investments are to be taken over by bank in full settlement of overdraft balance.
(vi) Preference shareholders have agreed to give up their right for 2 years' dividend and accept 12 fully paid Equity Shares of ₹ 5 each for each fully paid Preference Share.

Give necessary Journal Entries and draft a Balance Sheet after such reconstruction.

[C.A. (Inter) — Adapted]

Solution

In the books of Hopeful Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 April 1	Bank A/c	Dr.		1,00,000	
	To Equity Share Capital A/c				1,00,000
	(Being the amount of call money received on 40,000 Shares @ ₹ 2.50 per Share, credited to Share Capital Account)				
	Equity Share Capital (₹ 10) A/c	Dr.		4,00,000	
	To Equity Share Capital (₹ 5) A/c				2,00,000
	To Capital Reduction A/c				2,00,000
	(Being 40,000 Equity Shares of ₹ 10 each fully paid reduced to 40,000 Equity Shares of ₹ 5 each fully paid as per Special Resolution no ... dated .... as confirmed by the Tribunal)				
	Capital Reduction A/c	Dr.		9,600	
	To Provision for Sales Tax A/c				9,600
	(Being the adjustment for sales tax provision)				
	Provision for Sales Tax A/c	Dr.		9,000	
	To Bank A/c				9,000
	(Being the payment of sales tax to the extent of ₹ 9,000)				
	Land and Building A/c	Dr.		60,000	
	To Capital Reduction A/c				60,000
	(Being the appreciation in the value of Land and Building credited to Capital Reduction Account as per Scheme of reconstruction)				
	Capital Reduction A/c	Dr.		20,000	
	To Goodwill A/c				20,000
	(Being Goodwill written off as per Scheme of Reconstruction dated ....)				
	Trade Creditors A/c	Dr.		21,000	
	To Bank A/c				9,000
	To Capital Reduction A/c				12,000
	(Being the amount paid to creditors ₹ 9,000 and amount sacrificed ₹ 12,000 credited to Capital Reduction A/c as per Scheme of Reconstruction, dated ....)				
	Bank Overdraft A/c	Dr.		16,800	
	Capital Reduction A/c	Dr.		7,200	
	To Investment A/c				24,000
	(Being the investment of ₹ 24,000 taken over by bank in full settlement of bank overdraft of ₹ 16,800, the difference debited to Capital Reduction A/c as per Scheme of Capital Reduction dtd. ...)				
	9% Preference Share Capital A/c	Dr.		2,00,000	
	To Equity Share Capital (₹ 5) A/c				1,20,000
	To Capital reduction A/c				80,000
	(Being the amount sacrificed by the 9% Pref. Shareholders @ ₹ 40 on 2,000 shares credited to Capital Reduction A/c, the balance converted into Equity Shares of ₹ 5 each fully paid as per Scheme of Reconstruction, dated .....)				
	Capital Reduction A/c	Dr.		3,15,200	
	To Profit and Loss A/c				1,42,800
	To Capital Reserve A/c (Note 1)				1,72,400
	(Being the balance of Capital Reduction A/c used for writing off the debit balance of Profit and Loss A/c and the balance trans. to Capital Reserve A/c as per Scheme of reconstruction, dtd. ...)				

Solution

Hopeful Ltd (and Reduced)
Balance Sheet as at 1st April, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,20,000
(b) Reserves and Surplus	(2)	1,72,400
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings (Unsecured)		80,000
(b) Trade Payables		27,000
(c) Other Current Liabilities		—
(d) Short-term Provisions (Sales Tax)		600
TOTAL		6,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets	(3)	3,40,000
(i) Tangible Assets		—
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		54,000
(c) Trade Receivables		1,18,000
(d) Cash and Cash Equivalents (82,000 + 6,000)		88,000
TOTAL		6,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
80,000 Equity Shares of ₹ 10 each reduced to shares of ₹ 5 each vide scheme of reconstruction	4,00,000
2,000, 9% Preference Shares of ₹ 100 each	2,00,000
	6,00,000
Issued and Subscribed Capital :	
64,000 Equity Shares of ₹ 5 each fully paid (including 24,000 shares issued to Preference Shareholders for consideration other than cash)	3,20,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve	1,72,400
(3) Fixed Assets	
Tangible Assets :	
Land and Building	2,20,000
Plant and Machinery	1,20,000
	3,40,000
Intangible Assets :	
Goodwill	20,000
Less: Written-off as per scheme	20,000
	Nil

Working Notes :

Dr. **(1) Capital Reduction Account** **Cr.**

Particulars	₹	Particulars	₹
To Provision for Sales Tax A/c	9,600	By Equity Share Capital (₹ 10) A/c	2,00,000
To Goodwill A/c	20,000	By Land and Building A/c	60,000
To Investment A/c	7,200	By Trade Creditors A/c	12,000
To Profit and Loss A/c	1,42,500	By 9% Preference Share Capital A/c	80,000
To Capital Reduction A/c (Balancing figure)	1,72,400		
	3,52,000		3,52,000

(2) Total amount provided for sales tax is ₹ 9,600. ₹ 9,000 is paid immediately. Therefore, ₹ 600 is to be shown as a current liability in the Balance Sheet.

(3) Cash at bank = ₹ 1,00,000 – ₹ 9,000 – ₹ 9,000 = ₹ 82,000.

Illustration 19

Following is the summarised Balance Sheet of XYZ Ltd as on 31st March, 2016 :

Balance Sheet XYZ Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	26,00,000
(b) Reserves and Surplus — Profit and Loss Account		(7,18,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 11% Debentures		10,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Loans from Directors		15,000
(b) Trade Payables — Trade Creditors		6,20,000
TOTAL		35,17,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		8,50,000
Furniture and Fittings		1,60,000
(ii) Intangible Assets :		
Patent and Copyrights		60,000
Goodwill		35,000
(b) Non-current Investment — at cost		65,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		13,00,000
(c) Trade Receivables — Sundry Debtors		12,00,000
(d) Cash and Cash Equivalents	(2)	(1,53,000)
TOTAL		35,17,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
1,80,000 Equity Shares of ₹ 10 each fully paid	18,00,000
8,000, 7.5% Preference Shares of ₹ 100 each fully paid	8,00,000
	26,00,000
(3) Cash and Cash Equivalents	
Cash in Hand	12,000
Bank Overdraft	(1,65,000)
	(1,53,000)

Due to heavy losses and overvaluation of assets, the following scheme of reconstruction was finalised:

(i) Preference shareholders will surrender their 20% shares and they have been allotted 9% (new) preference shares for the remaining amount.

(ii) Debentureholders having charge on plant and machinery would accept plant and machinery in full settlement.

(iii) Trade creditors accepted to take over the stock upto the value of ₹ 6,20,000.

(iv) Equity shareholders are to accept reduction of ₹ 4 per share.

(v) Investments to be valued at market price i.e. ₹ 60,000.

(vi) Sundry debtors and remaining stock is to be valued at 90% of their book value.
(vii) Directors have to forego their loan in full.
(viii) Patents and Copyright and Goodwill have no more value.

Pass necessary journal entries in the books of XYZ Ltd assuming that all the legal formalities have been completed. Prepare Capital Reduction Account and Balance Sheet of the company after reduction.

[C.A. (IPCC) — Adapted]

Solution

In the books of XYZ Ltd
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Mar 31	7.5% Preference Share Capital A/c	Dr.		8,00,000	
	To 9% Preference Share Capital A/c				6,40,000
	To Capital Reduction A/c				1,60,000
	(Being the surrender of 20%, 7.5% preference shares by preference shareholders. 9% preference shares issued for 80% amount of preference capital as per scheme of reconstruction)				
	11% Debentures A/c	Dr.		10,00,00	
	To Plant and Machinery A/c				8,50,000
	To Capital Reduction A/c				1,50,000
	(Being the plant and machinery taken over by 11% debentureholders in full satisfaction of their claim. The balance amount of claim of debentureholders transferred to Capital Reduction Account as per reconstruction scheme)				
	Trade Creditors A/c	Dr.		6,20,000	
	To Stock A/c				6,20,000
	(Being the stock taken over by the trade creditors as per the scheme of reconstruction)				
	Equity Share Capital A/c (₹ 10)	Dr.		18,00,000	
	To Equity Share Capital A/c (₹ 6)				10,80,000
	To Capital Reduction A/c				7,20,000
	(Being 1,80,000 equity shares of ₹ 10 reduced to 1,80,000 equity shares of ₹ 6 each as per the scheme of reconstruction)				
	Loan from Directors A/c	Dr.		15,000	
	To Capital Reduction A/c				15,000
	(Being the amount foregone by the directors as per scheme of reconstruction)				
	Capital Reduction A/c	Dr.		10,45,000	
	To Profit and Loss A/c				7,18,000
	To Goodwill A/c				35,000
	To Patents and Copyright A/c				60,000
	To Provision for Bad Debts A/c				1,20,000
	To Investment A/c				5,000
	To Stock A/c				68,000
	To Capital Reserve A/c				39,000
	(Being the balance of Capital Reduction Account used for writing off Profit and Loss debit balance, Goodwill, Patents and Copyrights, Debtors, Investments and Stock as per the scheme of reconstruction)				

Working Notes :

Dr. **(1) Capital Reduction Account** **Cr.**

Particulars	₹	Particulars	₹
To Profit and Loss A/c	7,18,000	By 7.5% Preference Share Capital A/c	1,60,000
To Goodwill A/c	35,000	By 11% Debentures A/c	1,50,000
To Patents and Copyrights A/c	60,000	By Equity Share Capital A/c	7,20,000
To Provision for Bad Debts A/c	1,20,000	By Loan from Director A/c	15,000
To Investment A/c	5,000		
To Stock A/c	68,000		
To Capital Reserve A/c (Balancing figure)	39,000		
	10,45,000		10,45,000

XYZ Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	17,20,000
(b) Reserves and Surplus	(2)	39,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
TOTAL		17,59,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	1,60,000
(b) Non-current Investments	(4)	60,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(5)	6,12,000
(c) Trade Receivables	(6)	10,80,000
(d) Cash and Cash Equivalents		(1,53,000)
TOTAL		17,59,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	***
... Preference Shares of ₹ ... each	***
Issued and Subscribed Capital :	
1,80,000 Equity Shares of ₹ 6 each fully paid	10,80,000
6,400, 9% Preference Shares of ₹ 100 each fully paid	6,40,000
	17,20,000

(5) Inventories

Particulars	₹
(5) Inventories	13,00,000
Less: Taken over by Trade Creditors	6,20,000
	6,80,000
Less: Written-off as per reconstruction scheme	68,000
	6,12,000

(2) Reserve and Surplus

Particulars		₹
Capital Reserve		39,000
(3) Fixed Assets		
Tangible Assets :		
Plant and Machinery	8,50,000	
Less: Taken over by Debentureholders	8,50,000	Nil
Furniture and Fittings		1,60,000
		1,60,000
(4) Trade Receivables		12,00,000
Less: Provision for Bad Debts		1,20,000
		10,80,000
(6) Non-Current Investments		65,000
Less: Written off as per scheme		5,000
		60,000

Illustration 20

The following is the Balance Sheet of Rocky Ltd. as at March 31, 2016 :

Balance Sheet of Rocky Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹ in Lakhs)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 50,00,000 Eqity Shares of ₹ 10 each		500
(b) Reserves and Surplus — Capital Account		6
Profit and Loss Account		(398)

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 12% Debentures		400
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Trade Creditors		165
(c) Other current liabilities	(1)	69
(d) Short-term provisions		33
TOTAL		775
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		142
Plant and Machinery		80
Furniture and Fixtures		27
(ii) Intangible Assets — Goodwill		15
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		142
(c) Trade Receivables — Debtors		80
(d) Cash and Cash Equivalents		27
TOTAL		775

Notes to Accounts :

(1) Share Capital

Particulars	₹ in Lakhs
(1) Other Current Liabilities	
Debenture Interest Oustanding	48
Director's Remuneration Outstanding	10
Other Outstanding Expenses	11
	69

The following scheme of internal reconstruction was framed, approved by the Tribunal, all the concerned parties and implemented:

(i) All the equity shares be converted into the same number of fully-paid equity shares of ₹ 2.50 each.

(ii) Directors agree to forego their outstanding remuneration.

(iii) The debentureholders also agree to forego outstanding interest in return of their 12% debentures being converted into 13% debentures.

(iv) The existing shareholders agree to subscribe for cash, fully paid equity shares of ₹ 2.50 each for ₹ 125 lacs.

(v) Trade creditors are given the option of either to accept fully paid equity shares of ₹ 2.50 each for the amount due to them or to accept 80% of the amount due in cash. Creditors for ₹ 65 lacs accept equity shares whereas those for ₹ 100 lacs accept ₹ 80 lacs in cash in full settlement.

(vi) The assets are revalued as under :

	₹ in Lacs
Land and Building	230
Plant and Machinery	220
Stock	120
Debtors	76

Pass Journal Entries for all the above mentioned transactions and draft the company's Balance Sheet immediately after the reconstruction.

[C.A. (Inter) — Adapted]

Solution

In the books of Rocky Ltd

Journal

Date	Particulars		L.F.	Dr. ₹ in lacs	Cr. ₹ in lacs
2016 March 31	Equity Share Capital (₹ 10) A/c	Dr.		500	
	To Equity Share Capital (₹ 2.50) A/c				125
	To Reconstruction A/c				375
	(Being the conversion of all equity shares of ₹ 10 each into the same number of fully paid equity shares of ₹ 2.50 each as per Reconstruction Scheme confirmed by Tribunal vide order dated . . .)				
	Director's Remuneration Outstanding A/c	Dr.		10	
	To Reconstruction A/c				10
	(Being the outstanding remuneration foregone by the directors as per Reconstruction Scheme confirmed by the Tribunal vide order . . . dated . . .				
	12% Debentures A/c	Dr.		400	
	Debenture Interest Outstanding A/c	Dr.		48	
	To 13% Debentures A/c				400
	To Reconstruction A/c				48
	(Being 12% Debentures converted into 13% Debentures on their agreeing to sacrifice interest outstanding of ₹ 48 lakhs, as per Reconstruction Scheme confirmed by the Tribunal)				
	Bank A/c	Dr.		125	
	To Equity Share Application A/c				125
	(Being application money received for 50 lakhs shares @ ₹ 2.50 each)				
	Equity Share Application A/c	Dr.		125	
	To Equity Share Capital A/c				125
	(Being the issue of 50 lakhs equity shares of ₹ 2.50 each as fully paid as per Board's Resolution No. . . . dated . . .)				
	Trade Creditors A/c	Dr.		165	
	To Equity Share Capital A/c				65
	To Bank A/c				80
	To Reconstruction A/c				20
	(Being trade creditors for ₹ 65 lakhs accepting shares for full amount and those for 100 lakhs accepting cash equal to 80% of claim in full settlement as per Reconstruction Scheme confirmed by Tribunal)				
	Capital Reserve A/c	Dr.		6	
	To Reconstruction A/c				6
	(Being capital reserve used for the purpose of reconstruction)				
	Land and Building A/c	Dr.		46	
	To Reconstruction A/c				46
	(Being the appreciation in the value of land and building credited to Reconstruction Account as per scheme of reconstruction)				
	Reconstruction A/c	Dr.		505	
	To Profit and Loss A/c				398
	To Plant and Machinery A/c				66
	To Stock A/c				22
	To Debtors A/c				4
	To Goodwill A/c				15
	(Being the balance of Reconstruction Account utilised for writing-off the debit balance of Profit and Loss Account and for writing down the value of fixed assets and goodwill as per scheme of reconstruction)				

Rocky Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount ₹ in Lacs)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	315
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	400
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities	(4)	11
(d) Short-term Provisions		33
TOTAL		759
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	491
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories (142 lakhs *Less* written off 22 lakhs)		120
(c) Trade Receivables	(5)	76
(d) Cash and Cash Equivalents (W.N. 2)		72
TOTAL		759

Notes to Accounts :

(1) Share Capital

Particulars	₹ in lacs
Authorised Capital :	
... Equity Shares of ₹ ... each	**
Issued and Subscribed Capital :	
1,26,000 Equity Sh. of ₹ 2.50 each fully paid (Note 1) (26,00,000 shares have been issued for consideration other than cash)	315

(5) Trade Receivables

Particulars	₹ in lacs
(5) Trade Receivables	80
Less: Provision for Bad Debts	4
	76

(2) Long-term Borrowings

Particulars	₹ in lacs
Secured Loans :	
13% Debentures	400

(3) Fixed Assets

Particulars	₹ in lacs
Tangible Assets :	
Land and Building	230
Plant and Machinery	220
Furnitures and Fixtures	41
	491

(4) Other Current Liabilities

Particulars	₹ in lacs
Outstanding Expenses	11

Working Notes :

(1) Equity Share Capital (after reconstruction)

Particulars	₹ in Lacs
Old equity share capital	125
Add: Fresh issue	125
Add: Equity shares issued to creditors	65
	315

(2) Cash at Bank as on 31.3.2016

Particulars	₹ in Lacs
Cash at bank (before reconstruction)	27
Add: Proceeds from issue of equity shares	125
	152
Less: Paid to creditors	80
	72

Dr. **(3) Reconstruction Account** **Cr.**

Particulars	₹ in Lacs	Particulars	₹ in Lacs
To Profit and Loss A/c	398	By Equity Share Capital A/c	375
To Plant and Machinery A/c	66	By Director's Remuneration Outstanding A/c	10
To Stock A/c	22	By Debenture Interest Outstanding A/c	48
To Debtors A/c	4	By Trade Creditors A/c	20
To Goodwill A/c	15	By Capital Reserve A/c	6
		By Land and Building A/c	46
	505		505

Illustration 21

Paradise Limited which had experienced trading difficulties decided to re-organise its finances on 31st March 2016 a final Trial Balance extracted from the books of the company showed the following position :

Particulars	Cr. (₹)	Particulars	Dr. (₹)
Share Capital, Authorished and Issued :		Profit and Loss A/c	1,17,625
1,500, 6% Cumulative Pref. Shares of ₹ 100 each	1,50,000	Goodwill at Cost	50,000
2,000 Equity Shares of ₹ 100 each	2,00,000	Debtors	30,200
Capital Reserve	36,000	Leasehold Property at Cost	80,000
Trade Creditors	42,500	Plant and Machinery at Cost	2,10,000
Bank Overdraft	51,000	Stock-in-trade	79,175
LeaseHold property, Provision for Depreciation	30,000		
Plant and Machinery, Provision for Depreciation	57,500		
	5,67,000		5,67,000

The approval of the Tribunal was obtained for the following scheme for reduction of capital :

(a) The Preference Shares to be reduced to ₹ 75 per share.

(b) The Equity Shares to be reduced to ₹ 12.50 per share.

(c) One ₹ 12.50 Equity Share to be issued for each ₹ 100 of Gross Preference Dividend Arrears, the Preference Dividend had not been paid for three years.

(d) The balance in Capital Reserve Account to be utilised.

(e) Plant and Machinery to be written-down to ₹ 75,000.

(f) The Profit and Loss Account balance and all intangible assets to be written-off.

At the same time as the Resolution to reduce Capital was passed another Resolution was approved restoring the total Authorised Capital to ₹ 3,50,000 consisting of 1,500, 6% Cumulative Preference Shares of ₹ 75 each and the balance in Equity Shares of ₹ 12.50 each. As soon as the above Resolutions had been passed, 5,000 Equity Shares were issued at par, for cash, payable in full upon application. The same were fully subscribed and paid.

You are required :

(i) to show the Journal Entries necessary to record the above transactions in the company's books; and

(ii) to prepare the Balance Sheet of the Company, after completion of the scheme.

[C.A. (Inter) — Adapted]

Solution

In the books of Paradise Ltd
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 March 31	6% Cum. PreferenceShare Capital (₹ 100) A/c Dr.		1,50,000	
	To 6% Cum. Preference Share Capital (₹ 75) A/c			1,12,500
	To Capital Reduction A/c			37,500
	(Being 1,500, 6% Cum. Pref. Sh. of ₹ 100 each fully paid converted into 6% Cum. Pref. Shares of ₹ 75 each fully paid; the balance of the amount transferred to Capital Reduction A/c as per the Scheme of Reconstruction confirmed by the Tribunal *vide* order dated ....)			
	Equity Share Capital (₹ 100) A/c Dr.		2,00,000	
	To Equity Share Capital (₹ 12.50) A/c			25,000
	To Capital Reduction A/c			1,75,000
	(Being 2,000 Equity Shares of ₹ 100 each fully paid converted into Equity Shares of ₹ 12.50 each fully paid; the balance transferred to Capital Reduction A/c as per the Scheme of Reconstruction confirmed by the Tribunal *vide* order dated ....)			

Capital Reserve A/c Dr. To Capital Reduction A/c (Being the balance of Capital Reserve A/c transferred to Capital Reduction Account as per the Scheme of Reconstruction dated ....)		36,000	36,000
Capital Reduction A/c Dr. To Equity Share Capital A/c (Being the issue of 270 Equity Shares of ₹ 12.50 each fully paid to Preference Shareholders in settlement of their claim for arrears of dividend @ 1/8 of the amount due, ₹ 27,000 as per Scheme of Reconstruction confirmed by the Tribunal *vide* order dated ....)		3,375	3,375
Capital Reduction A/c Dr. To Plant and Machinery A/c (Being the value of Plant and Machinery reduced to ₹ 75,000 as per Scheme of Reconstruction dated ...)		77,500	77,500
Bank A/c Dr. To Equity Share Application A/c (Being application money received on 5,000 Equity Shares @ ₹ 12.50 each)		62,500	62,500
Equity Share Application A/c Dr. To Equity Share Capital A/c (Being the allotment of 5,000 Eq. Share of ₹ 12.50 each as per Board's Resolution no. ... dtd. ...)		62,500	62,500
Capital Reduction A/c Dr. To Profit and Loss A/c To Goodwill A/c (Being the balance of Capital Reduction Account used for writing off P/L A/c debit balance and Goodwill as per scheme of reconstruction)		1,67,625	1,17,625 50,000

Paradise Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,03,375
(b) Reserves and Surplus		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(2)	42,500
(c) Other Current Liabilities		—
(d) Short-term Provisions		—
TOTAL		2,45,875
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	1,25,000
(ii) Intangible Assets	(3)	Nil
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(4)	79,175
(c) Trade Receivables	(5)	30,200
(d) Cash and Cash Equivalents (₹ 62,500 – ₹ 51,000)		11,500
TOTAL		2,45,875

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
19,000 Equity Shares of ₹ 12.50 each	2,37,500
1,500, 6% Cumulative Pref. Shares of ₹ 75 each	1,12,500
	3,50,000
Issued and Subscribed Capital :	
7,270 Equity Shares of ₹ 12.50 each fully paid (270 shares of ₹ 12.50 each issued for consideration other than cash)	90,875
1,500, 6% Cumulative Pref. Sh. of ₹ 75 each fully paid	1,12,500
	2,03,375
(2) Trade Payables	42,500

(3) Fixed Assets

Particulars		₹
Tangible Assets :		
Plant and Machinery	2,10,000	
Less: Written-off as per scheme	77,500	
	1,32,500	
Less: Provision for Depreciation	57,500	75,000
Leasehold Property	80,000	
Less: Provision for Depreciation	30,000	50,000
		1,25,000
Intangible Assets :		
Goodwill		50,000
Less: Written-off as per scheme		50,000
		Nil
(4) Inventories		
Stock		79,175
(5) Trade Receivables		
Debtors		30,200

Illustration 22

X Ltd., whose Balance Sheet as at 31st December, 2015 appears below formulated a scheme of reconstruction, details of which follow and secured approval of all concerned.

Balance Sheet of X Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus — Profit and Loss Account		(2,14,000)
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 8% Debentures		3,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		75,000
(b) Trade Payables — Sundry Creditors		34,500
(c) Other current liabilities :		
Interest accrued and due on Debentures		54,000
Interest on Bank Loan		7,500
TOTAL		10,57,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		5,60,000
(ii) Intangible Assets :		
Patents and Copyrights		40,000

(2) Current Assets :		
(a) Current Investments (Market value ₹ 27,500)		32,500
(b) Inventories		—
(c) Trade Receivables — Sundry Debtors		60,000
(d) Cash and Cash Equivalents		—
(e) Short-term Loans and Advances		—
(f) Other Current Assets		3,64,500
TOTAL		10,57,000

Notes to Accounts :

(1) Share Capital

Particulars	
Issued, Subscribed and Paid-up Capital :	
50,000 Equity Shares of ₹ 20 each, ₹ 10 paid-up	5,00,000
40,000, 8% Preference Shares of ₹ 100 each, ₹ 75 paid-up	3,00,000
	8,00,000

Preference dividend is in arrears for one year.

(a) Preference shareholders to give up their claims inclusive of dividends to the extent of 30% and desire to be paid-off.

(b) Debentureholders agree to give up their claims to interest in consideration of their rate of interest being enhanced to 10%.

(c) Bank agrees to give up 50% of their interest outstanding in consideration of their being paid-off at once;

(d) Sundry creditors would like to grant a discount of 5% if they were to be paid-off immediately.

(e) Balances on Profit and Loss Account, Patents and Copyrights and 25% of the total Sundry Debtors of ₹ 60,000 to be written-off. Fixed assets to be written-down by ₹ 7,000. Investments to reflect their market value.

(f) To the extent not specifically stated equity shareholders suffer no reduction of their rights.

(g) Costs of reconstruction ₹ 1,675.

Pass Journal Entries in the books of the company assuming that the scheme has been put through fully with the equity shareholders bringing in necessary cash to pay-off the parties and to leave a working capital of ₹ 10,000. Please draw the Balance Sheet after reconstruction. ***[C.A. (Inter) — Adapted]***

Solution

In the books of X Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2015 Dec 31	8% Preference Share Capital A/c	Dr.		3,00,000	
	To Preference Shareholders A/c				2,10,000
	To Reconstruction A/c				90,000
	(Being 30% of the Capital sacrificed by the Preference shareholders credited to Reconstruction Account and the balance amount credited to Pref. Shareholders Account for payment in cash as per Reconstruction Scheme confirmed by the Tribunal *vide* order dtd. ...)				
	Reconstruction A/c (Note 1)	Dr.		16,800	
	To Preference Shareholders A/c				16,800
	(Being 70% of the arrears of dividend of ₹ 24,000 credited to Pref. Shareholders A/c as per Reconstruction Scheme confirmed by the Tribunal *vide* order dtd. ...)				
	9% Debentures A/c	Dr.		3,00,000	
	Interest Accrued and Due A/c	Dr.		54,000	
	To Reconstruction A/c				54,000
	To 10% Debentures A/c				3,00,000
	(Being 9% Debentures converted into 10% Debentures on their agreeing to sacrifice interest accrued and due of ₹ 54,000, as per Reconstruction Scheme dated ... confirmed by the Tribunal)				
	Bank Loan A/c	Dr.		75,000	
	Interest on Bank Loan A/c	Dr.		7,500	
	To Bank A/c				78,750
	To Reconstruction A/c				3,750
	(Being the payment of Bank Loan and 50% of Interest on Bank Loan, the balance 50% of the interest sacrificed by the bank transferred to Recon. A/c as per Reconsruction Scheme dtd. ...)				

			Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c (Note 2) Dr. To Reconstruction A/c (Being 50,000 Equity Shares of ₹ 20 each, ₹ 10 paid reduced to 50,000 Shares of ₹ 17 each, ₹ 7 paid for as per Reconstruction Scheme dated ...)		1,50,000	1,50,000
	Bank A/c (Note 3) Dr. To Equity Share Capital A/c (Being the amount called on 50,000 Shares @ ₹ 7 each to provide for payment to Preference Shareholders, Bank Overdraft, Sundry Creditors, expenses of reconstruction and to provide for working capital)		3,50,000	3,50,000
	Preference Shareholders A/c Dr. To Bank A/c (Being the amount due to Preference Shareholders paid as per Reconstruction Scheme)		2,26,800	2,26,800
	Sundry Creditors A/c Dr. To Bank A/c To Reconstruction A/c (Being 95% of the Interest due on overdraft paid and the balance 5% transferred to Reconstruction Account as per Reconstruction Scheme)		34,500	32,775 1,725
	Reconstruction A/c Dr. To Profit and Loss A/c To Patents and Copyrights A/c To Investments A/c To Sundry Debtors A/c To Fixed Assets A/c To Bank (Expenses) A/c (Being the balance of Reconstruction A/c used for writing off the debit balance of Profit and Loss Account and other assets as per Reconstruction Scheme no.. ... dated .....)		2,82,675	2,14,000 40,000 5,000 15,000 7,000 1,675

X Ltd (and Reduced)
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,00,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	3,00,000
(4) Current Liabilities :		—
TOTAL		10,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	5,53,000
(ii) Intangible Assets	(3)	Nil
(2) Current Assets :		
(a) Current Investments	(4)	27,500
(b) Inventories		—
(c) Trade Receivables	(5)	45,000
(d) Cash and Cash Equivalents		10,000
(e) Other Current Assets		3,64,500
TOTAL		10,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	***
Issued and Subscribed Capital :	
50,000 Equity Shares of ₹ 17 each, ₹ 14 paid-up	7,00,000

(2) Long-term Borrowings

Secured Loans :	
9% Debentures	3,00,000

(3) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	5,60,000
Less: Written-off as per scheme	7,000
	5,53,000
Intangible Assets :	
Patent and Copyright	40,000
Less: Written-off as per scheme	40,000
	Nil

(4) Current Investments

(4) Current Investments	32,500
Less: Written-off as per scheme	5,000
	27,500

(5) Trade Receivables

(5) Trade Receivables	60,000
Less: Written-off as per scheme	15,000
	45,000

Working Notes : (1) Preference dividend has not been provided in the books of account. Therefore, any amount to be paid should be debited to Reconstruction Account. Here, 70% of ₹ 24,000 was paid. Therefore, ₹ 16,800 is to be debited to Reconstruction Account.

(2) Amount to be Sacrificed by Equity Shareholders

Amount to be written off	₹	Sacrifices made by other parties	₹
Profit and Loss A/c	2,14,000	Preference Shareholders	90,000
Patents and Copyrights	40,000	Debentureholders	54,000
Debtors (25% of ₹ 60,000)	15,000	Bank	3,750
Investments	5,000	Sundry Creditors	1,725
Reconstruction Expenses	1,675		1,49,475
Plant and Machinery	7,000	Amount to be sacrificed by the Equity Shareholders	
Dividend to Preference Shareholders	16,800	@ ₹ 3 per Share	1,50,000
	2,99,475		2,99,475

(3) Cash to be contributed by Equity Shareholders

		₹
(i)	Payment to Preference Shareholders	2,26,800
(ii)	Payment of Bank Loan and Interest	78,750
(iii)	Payment of Sundry Creditors	32,775
(iv)	Payment of reconstruction expenses	1,675
(v)	Provision for Working Capital	10,000
	Total	3,50,000

Amount payable per Share = ₹ 3,50,000 / 50,000 = ₹ 7.

Illustration 23

The Balance Sheet of Bad Luck Co. Ltd. as at 31.12.2015 is as under :

Balance Sheet Bad Luck Co. Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 1,00,000 Equity Shares of ₹ 10 each fully paid-up		10,00,000
(b) Reserves and Surplus — Profit and Loss Account		(5,00,000)
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term borrowings — 4,000, 10% Debentures		4,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		1,60,000
(c) Other current liabilities — Intereset on Debentures		40,000
TOTAL		11,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant and Machinery		9,00,000
(ii) Intangible Assets — Goodwill		2,00,000
(2) Current Assets :		Nil
TOTAL		11,00,000

For the purpose of reconstruction of the Company, necessary Resolution are passed on the following lines :

(i) The Equity Shares are to be sub-divided into shares of ₹ 1 each and each shareholder shall surrender 60% of his holding.

(ii) Out of the surrendered shares, 60,000 shares will be converted to 8% Preference Shares of ₹ 10 each.

(iii) Debentureholders will reduce their total claims by ₹ 1,40,000 and in consideration the Debentureholders are to get the entire Preference Share Capital converted from shares surrendered.

(iv) Creditors' claims are to be reduced to ₹ 1,00,000 and in consideration they are to receive Equity Shares of Re 1 each amounting to ₹ 40,000 from the shares surrendered.

(v) Goodwill and Profit and Loss Account (Dr.) are to be written-off completely.

(vi) The remaining surrendered shares shall be cancelled.

You are required to give the Journal Entries and the Resultant Balance Sheet of the Company.

Solution

In the books of Bad Luck Co. Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Jan 1	Equity Share Capital (₹ 10) A/c	Dr.		10,00,000	
	To Equity Share Capital (₹ 1) A/c				10,00,000
	(Being 1,00,000 Equity Sh. of ₹ 10 each fully paid, sub-divided into 10,00,000 Equity Sh. of Re 1 each fully paid as per Special Resolution no. dtd. ... confirmed by the Tribunal *vide* order dtd. ...)				
	Equity Share Capital (₹1) A/c	Dr.		6,00,000	
	To Shares Surrendered A/c				6,00,000
	(Being the surrender of 60% Shares to the company as per Special Resolution no. ... dated ...)				
	Shares Surrendered A/c	Dr.		60,000	
	To 8% Preference Share Capital A/c				60,000
	(Being the conversion of Share Surrendered A/c to 6,000, 8% Pref. Shares ₹ 10 each fully paid for the purpose of issue to debentureholders as per Special Resolution no. ... dated ... confirmed by the Tribunal *vide* order dated.....)				
	Shares Surrendered A/c	Dr.		40,000	
	To Equity Share Capital (Re 1) A/c				40,000
	(Being the issue of 40,000 Equity Shares of Re 1 each to creditors as per Special Resolution no. ... dated.... confirmed by the Tribunal *vide* order dated.....)				
	Shares Surrendered A/c	Dr.		5,00,000	
	To Capital Reduction A/c				5,00,000
	(Being the balance of Share Surrendered A/c transferred to Capital Reduction A/c as per Reconstruction Scheme)				
	10% Debentures A/c	Dr.		1,00,000	
	Accrued Interest A/c	Dr.		40,000	
	To Capital Reduction A/c				1,40,000
	(Being the amount sacrificed by the debentureholders transferred to Capital Reduction A/c as per Special Resolution no. ... dated....)				

Sundry Creditors A/c Dr. To Capital Reduction A/c (Being the amount sacrificed by the creditors transferred as per Special Resolution no. ...dtd.....)		60,000	60,000
Capital Reduction A/c Dr. To Goodwill A/c To Profit and Loss A/c (Being the balance Capital Reduction Account used for writing off the debit balance of Profit and Loss Account and Goodwill as per scheme of reconstruction)		7,00,000	2,00,000 5,00,000

Bad Luck Ltd (and Reduced)
Balance Sheet as at 1st January, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	3,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	1,00,000
TOTAL		9,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant and machinery		9,00,000
(2) Current Assets :		Nil
TOTAL		9,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ₹ ... each	?
	?
Issued and Subscribed Capital :	
4,40,000 Equity Shares of ₹ 1 each fully paid	4,40,000
6,000, 8% Preference Shares of ₹ 10 each	60,000
	5,00,000

(2) Long-term Borrowings

Particulars	₹
Secured :	
3,000, 10% Debentures of ₹ 100 each	3,00,000

(3) Trade Receivables

Particulars	₹
Sundry Creditors	1,00,000

(4) Intangible Assets

Particulars	₹
Goodwill	2,00,000
Less : Written-off as per scheme	2,00,000
	Nil

Illustration 24

The position (besides accumulated loss) of Sunset Ltd. as on 31.03.2016 was as follows :

	₹
50,000 Equity Shares of ₹ 100 each	50,00,000
25,000, 9% Preference Shares of ₹ 100 each	25,00,000
Preference Dividend in arrear (not shown in Balance Sheet)	4,50,000
Creditors	12,50,000
Plant and Machinery	50,00,000
Other Current Assets	16,25,000

The following scheme of reconstruction was adopted :

(i) Plant and machinery and other current assets were revalued at ₹ 30,00,000 and ₹ 12,50,000 respectively.

(ii) The equity shares were sub-divided into shares of ₹ 5 each and 80% of these shares were surrendered.

(iii) The preference shareholders' claim was reduced by 50% and in consideration they were allotted shares out of shares surrendered account amounting to ₹ 6,25,000.

(iv) The creditors agreed to reduce their claim by ₹ 7,50,000, one-third of which was satisfied by the issue of equity shares out of those susrrendered.

(v) The remaining surrendered shares were cancelled.

Pass Journal Entries and prepare the Balance Sheet just after re-construction.

Solution

In the books of Sunset Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 Mar. 31	Equity Share Capital A/c (₹ 100)	Dr.		50,00,000	
	To Equity Share Capital A/c (₹ 5)				50,00,000
	(Being 50,000 equity shares of ₹ 100 each sub-divided into 10,00,000 equity shares of ₹ 5 each as per Special Resolution No. ... dated .... vide Tribunal Order No. ...)				
	Equity Share Capital A/c (₹ 5)	Dr.		40,00,000	
	To Share Surrender A/c				40,00,000
	(Being surrender of 8,00,000 equity shares of ₹ 5 each as per Special Resolution No. ... dt. ...)				
	Share Surrender A/c	Dr.		6,25,000	
	To Equity Share Capital A/c				6,25,000
	(Being the issue of 1,25,000 equity shares of ₹ 5 to preference shareholders as a consideration for reduction of their claim by 50% as per Special Resolution No. ... dt. ...)				
	9% Preference Share Capital A/c	Dr.		12,50,000	
	To Capital Reduction A/c				12,50,000
	(Being the claim of preference shareholders reduced by 50% as per scheme of reconstruction)				
	Share Surrender a/c	Dr.		2,50,000	
	To Equity Share Capital A/c				2,50,000
	(Being the issue of 50,000 equity shares of ₹ 5 to creditors as per the scheme of reconstruction)				
	Creditors A/c	Dr.		7,50,000	
	To Capital Reduction A/c				7,50,000
	(Being the amount sacrified by the creditors as per the scheme of reconstruction)				
	Share Surrender A/c	Dr.		31,25,000	
	To Capital Reduction A/c				31,25,000
	(Being the cancellation of balance of shares surrendered as per scheme of reconstruction)				
	Capital Reduction A/c (Note 2)	Dr.		51,25,000	
	To Profit and Loss A/c (Note 1)				21,25,000
	To Plant and Machinery A/c (50,00,000 – 30,00,000)				20,00,000
	To Other Current Assets A/c (16,25,000 – 12,50,000)				3,75,000
	To Capital Reserve A/c (Note 2)				6,25,000
	(Being the utilisation of Capital Reduction Account for writing off profit and loss (Dr.) balance, fixed assets, current assets, etc. as per the scheme of reconstruction. The balance of Capital Reduction Account transferred to Capital Reserve)				

Sunset Ltd (and Reduced)

Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	31,25,000
(b) Reserves and Surplus	(2)	6,25,000
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		

(4) Current Liabilities :		
(a) Trade Payables	(3)	5,00,000
TOTAL		42,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	30,00,000
(2) Current Assets :		
(a) Other Current Assets	(5)	12,50,000
TOTAL		42,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ₹ ... each	?
	?
Issued and Subscribed Capital :	
3,75,000 Equity Shares of ₹ 5 each fully paid	18,75,000
12,500, 9% Cumulative Preference Shares of ₹ 100 each	12,50,000
	31,25,000

(2) Reserve and Surplus

Capital Reserve	6,25,000

(3) Trade Payables

Particulars		₹
Creditors	12,50,000	
Less: Sacrificed as per Scheme	7,50,000	5,00,000

(4) Fixed Assets

Tangible Assets :	
Plant and Machinery	50,00,000
Less: Written off as per Scheme	20,00,000
	30,00,000

(5) Other Current Assets	16,25,000	
Less: Written off as per Scheme	3,75,000	12,50,000

Working Notes :

(1) In this problem, the balance of Profit and Loss Account has not been given. It has been calculated as follows :

Total Liabilities :		
Share Capital	75,00,000	
Creditors	12,50,000	87,50,000
Less: **Total Assets** :		
Plant and Machinery	50,00,000	
Other Current Assets	16,25,000	66,25,000
Profit and Loss (Debit Balance)		21,25,000

Dr. (2) Capital Reduction Account Cr.

Particulars	₹	Particulars	₹
To Profit and Loss A/c	21,25,000	By 9% Preference Share Capital A/c	12,50,000
To Fixed Assets A/c	20,00,000	By Creditors A/c	7,50,000
To Current Assets A/c	3,75,000	By Share Surrender A/c	31,25,000
To Capital Reserve A/c (Balancing figure)	6,25,000		
	51,25,000		51,25,000

Illustration 25

The business of Usha Limited was being carried on continuously at losses. The following are the extracts from the Balance Sheet of the company as on 31st March, 2016 :

Balance Sheet of Usha Limited as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus : Securities Premium		1,80,000
Profit and Loss Account		(4,10,000)

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Unsecured Loans from Directors		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		6,00,000
(c) Other current liabilities — Outstanding Expenses (including Directors' Remuneratrion ₹ 40,000)		1,40,000
TOTAL		16,10,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant		6,00,000
Furniture		20,000
(ii) Intangible Assets — Goodwill		1,00,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories — Stock		3,00,000
(c) Trade Receivables —Debtors		5,00,000
(d) Cash and Cash Equivalents — Cash at Bank		90,000
TOTAL		16,10,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
60,000 Equity Shares of ₹ 10 each	6,00,000
4,000, 9% Preference Shares of ₹ 100 each	4,00,000
	10,00,000
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
4,000, 9% Preference Shares of ₹ 100 each fully paid	4,00,000
	10,00,000

Note : Dividend on cumulative preference shares are in arrears for the last three years.

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

(i) Equity shares to be converted into 3,00,000 equity shares of ₹ 2 each and then the equity shareholders are to surrender to the company 90% of their holding.

(ii) Prefernce shareholders agree to forego their right to arrears of dividend in consideration of which their 9% preference shares are to be converted into equal number of 10% preference shares.

(iii) Sundry creditors agree to reduce their claim by 1/5th in consideration of their getting shares of ₹ 70,000 out of the surrendered equity shares.

(iv) The directors agree to forego the amounts due on account of unsecured loan and director's remuneration.

(v) The surrendered shares not utilised are to be cancelled.

(vi) Assets are to be reduced as follows : Goodwill by ₹ 1,00,000; Plant by ₹ 1,14,000; Furniture by ₹ 6,000; Sundry debtors by ₹ 30,000; Stock by ₹ 50,000.

(vii) Expenses of reconstruction amounted to ₹ 20,000.

(viii) Further, 1,00,000 equity shares of ₹ 2 each were issued to the existing members for increasing the working capital. The issue was fully subscribed and paid-up. The authorised capital was suitably increased.

A member holding 100 equity shares opposed the scheme and his shares were taken over by a director on payment of ₹ 1,000 as fixed by the Tribunal.

You are required to pass the journal entries for giving effect to the above arrangement. Also draw up the Balance Sheet of the company immediately after the above mentioned transactions.

Solution

In the books of Usha Limited
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016 March 31	Equity Share Capital (₹ 10) A/c	Dr.		6,00,000	
	To Equity Share Capital (₹ 2) A/c				6,00,000
	(Being 60,000 equity shares of ₹ 10 each fully paid, sub-divided into 3,00,000 equity shares of ₹ 2 each fully paid as per Special Resolution No. . . . dated . . . as confirmed by the Tribunal vide Order dated . . .)				
	Equity Share Capital (₹ 2) A/c	Dr.		5,40,000	
	To Share Surrendered A/c				5,40,000
	(Being the surrender of 90% equity shares to the company as per scheme of reconstruction)				
	9% Cumulative Preference Share Capital A/c	Dr.		4,00,000	
	To 10% Cumulative Preference Share Capital A/c				4,00,000
	(Being 4,000, 9% cumulative preference shares of ₹ 100 each fully paid converted into 4,000, 10% cumulative preference shares of ₹ 100 each fully paid as per the scheme of reconstruction)				
	Share Surrendered A/c	Dr.		70,000	
	To Equity Share Capital (₹ 2) A/c				70,000
	(Being the issue of 35,000 equity shares of ₹ 2 each to sundry creditors on their surrendering 1/5 of their claim as per the scheme of reconstruction)				
	Shares Surrendered A/c	Dr.		4,70,000	
	To Capital Reduction A/c				4,70,000
	(Being the balance of Shares Surrendered Account transferred to Capital Reduction Account as per the scheme of reconstruction)				
	Unsecured Loan A/c	Dr.		1,00,000	
	Sundry Creditors A/c	Dr.		1,20,000	
	Outstanding Expenses A/c	Dr.		40,000	
	To Capital Reduction A/c				2,60,000
	(Being the amount sacrificed by various parties, transferred to Capital Reduction Account as per the scheme of reconstruction)				
	Capital Reduction A/c	Dr.		20,000	
	To Bank A/c				20,000
	(Being the payment of expenses of reconstruction)				
	Capital Reduction A/c (Note 1)	Dr.		7,10,000	
	To Goodwill A/c				1,00,000
	To Plant A/c				1,14,000
	To Furniture A/c				6,000
	To Sundry Debtors A/c				30,000
	To Stock A/c				50,000
	To Profit and Loss A/c				4,10,000
	(Being the balance of Capital Reduction Account used for writing-off goodwill, plant, furniture, sundry debtors, stock and debit balance of Profit and Loss Account as per scheme of reconstruction)				
	Bank A/c	Dr.		2,00,000	
	To Equity Share Application A/c				2,00,000
	(Being application money received for 1,00,000 equity shares @ ₹ 2 each)				
	Equity Share Application A/c	Dr.		2,00,000	
	To Equity Share Capital (₹ 2) A/c				2,00,000
	(Being the issue of 1,00,000 equity shares of ₹ 2 each as per Board's Resolution No. . . . dated . . .)				

Usha Ltd (and Reduced)
Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,30,000
(b) Reserves and Surplus	(2)	1,80,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		4,80,000
(c) Other Current Liabilities (Outstanding Expenses)		1,00,000
TOTAL		14,90,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	5,00,000
(ii) Intangible Assets	(3)	Nil
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(4)	2,50,000
(c) Trade Receivables	(5)	4,70,000
(d) Cash and Cash Equivalents (Note 2)		2,70,000
TOTAL		14,90,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
3,00,000 Equity Shares of ₹ 2 each	6,00,000
4,000, 10% Cumulative Preference Sh. of ₹ 100 each	4,00,000
	10,00,000
Issued and Subscribed Capital :	
1,65,000 Equity Shares of ₹ 2 each fully paid	3,30,000
4,000, 10% Cumulative Preference Sh. of ₹ 100 each	4,00,000
	7,30,000

(2) Reserve and Surplus

Particulars	₹
Securities Premium (Note 3)	1,80,000

(3) Fixed Assets

Particulars		₹
Tangible Assets :		
Plant	6,00,000	
Less: Written-off as per scheme	1,14,000	4,86,000
Furniture	20,000	
Less: Written-off as per scheme	6,000	14,000
		5,00,000
Intangible Assets :		
Goodwill		1,00,000
Less: Written-off		1,00,000
		Nil

(4) Inventories

Particulars	₹
(4) Inventories	3,00,000
Less: Written-off as per scheme	50,000
	2,50,000

(5) Trade Receivables

Particulars	₹
(5) Trade Receivables	5,00,000
Less: Written-off as per scheme	30,000
	4,70,000

Working Notes :

Dr. (1) Capital Reduction Account Cr.

Particulars	₹	Particulars	₹
To Bank A/c (Expenses)	20,000	By Shares Surrendered A/c	4,70,000
To Goodwill A/c	1,00,000	By Unsecured Loan A/c	1,00,000
To Plant A/c	1,14,000	By Sundry Creditors A/c	1,20,000
To Furniture A/c	6,000	By Outstanding Expenses A/c	40,000

To Sundry Debtors A/c	30,000		
To Stock A/c	50,000		
To Profit and Loss A/c	4,10,000		
	7,30,000		7,30,000

Dr. **(2) Bank Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	90,000	By Capital Reduction A/c	20,000
To Equity Share Application A/c	2,00,000	By Balance c/d	2,70,000
	2,90,000		2,90,000

(3) Scheme is silent about Securities Premium Account. It has been assumed that Securities Premium Account is to be kept intact.

(4) No entry is required in the books of the company in respect of shares of dissident shareholders, taken over by the director, since it is not a transaction of the company.

Illustration 26

The Balance Sheet of Teesta Iron Products Limited as on 31.12.2015 is as under :

Balance Sheet of Teesta Iron Products Ltd. as at 31st December, 2015

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		(1)	3,90,000
(b) Reserves and Surplus — Profit and Loss Account			(1,90,000)
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings			—
(b) Trade Payables — Trade Creditors			3,50,000
TOTAL			5,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Freehold Properties			1,00,000
Plant and Machinery			1,30,000
(ii) Intangible Assets : Patents			40,000
(b) Non-current Investments :			
Investment in Subsidiary :			
Shares	96,000		
Advances	34,000		1,30,000
(2) Current Assets :			
(a) Current Investments			—
(b) Inventories — Stock			1,20,000
(c) Trade Receivables — Debtors			80,000
(d) Cash and Cash Equivalents — Overdraft			(50,000)
TOTAL			5,50,000

Notes to Accounts :

(1) Share Capital

Particulars	
Authorised Capital :	
35,000 Equity Shares of ₹ 10 each	3,50,000
35,000, 9% Preference Shares of ₹ 10 each	3,50,000
	7,00,000

Issued, Subscribed and Paid-up Capital :	
15,000 Equity Shares of ₹ 10 each, ₹ 6 paid-up	90,000
30,000, 9% Preference Shares of ₹ 10 each fully paid	3,00,000
	3,90,000

Note : The preference dividend are in arrears for 4 years.

The scheme of reconstruction is to take effect from 1.1.2016 had been duly approved and authorised by the Tribunal :

(a) The unpaid capital on the equity shares to be called up forthwith.

(b) The equity shares are to be sub-divided into shares of ₹ 1 each and each shareholder shall surrender 80% of his holding.

(c) The 9% cumulative preference shares together with all arrears of dividend to be surrendered and cancelled. The holders, for every 15 preference shares :

(i) are to pay ₹ 80 in cash;

(ii) will be issued 1, 10% mortgage debenture at ₹ 100 each; and

(iii) will receive 30 fully paid equity shares of ₹1 each being a re-distribution of those surrendered by the equity shareholders.

(d) The unpaid capital on the shares in the subsidiary to be called-up on 12,000 shares of ₹ 2 each and paid by the parent company.

(e) The adverse balance on Profit and Loss Account and the patents to be written off; ₹ 60,000 to be written off from the shares in the subsidiary; 10% provision for bad debts to be created. Stock to be reduced by ₹ 10,000 and the balance of the sums made available by the scheme to be used to write down the plant and machinery.

(f) Surrendered equity shares, not otherwise utilised, to be cancelled.

(g) Authorised capital remains the same except equity shares which will be ₹ 1 each.

You are required to pass journal entries for giving effect to the above arrangements and also to draw up the resultant Balance Sheet of the company.

Solution

In the books of Teesta Iron Products Limited.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2016	Equity Share Final Call A/c	Dr.		60,000	
Jan. 1	To Equity Share Capital A/c				60,000
	(Being the final call money due on 15,000 equity shares @ ₹ 4 each as per Board's Resolution No. . . . dated . . .)				
	Bank A/c	Dr.		60,000	
	To Equity Share Final Call A/c				60,000
	(Being the amount received in respect of final call)				
	Equity Share Capital (₹ 10) A/c	Dr.		1,50,000	
	To Equity Share Capital (Re 1) A/c				1,50,000
	(Being 15,000 equity shares of ₹ 10 each fully paid converted into 1,50,000 equity shares of Re 1 each as per Special Resolution No. . . . dated . . . as sanctioned by the Tribunal dated . . .)				
	Equity Share Capital (Re 1) A/c	Dr.		1,20,000	
	To Shares Surrendered A/c				1,20,000
	(Being the surrender of 80% equity shares as per the scheme of reconstruction)				
	9% Cumulative Preference Share Capital A/c	Dr.		3,00,000	
	To Capital Reduction A/c				3,00,000
	(Being the cancellation of 30,000, 9% cumulative preference shares of ₹ 10 each fully paid-up as per the scheme of reconstruction)				
	Shares Surrendered A/c	Dr.		1,00,000	
	Bank A/c (Note 1)	Dr.		1,60,000	
	To 10% Mortgage Debentures A/c				2,00,000
	To Equity Share Capital A/c				60,000
	(Being the issue of 2,000, 10% mortgage debentures of ₹ 100 each and issue of 60,000 equity shares of Re 1 each fully paid to the holders of preference shares out of shares surrendered as per the scheme of reconstruction)				

Shares Surrendered A/c (₹ 1,20,000 – ₹ 1,00,000) Dr.		20,000	
To Capital Reduction A/c			20,000
(Being the balance of Shares Surrendered Account transferred to Capital Reduction Account as per the scheme of reconstruction)			
Investment in Shares of Subsidiary Company A/c Dr.		24,000	
To Bank A/c			24,000
(Being final call money paid on 12,000 shares of subsidiary company @ ₹ 2 each)			
Capital Reduction A/c Dr.		3,20,000	
To Profit and Loss A/c			1,90,000
To Patent A/c			40,000
To Investment in Shares of Subsidiary Company A/c			60,000
To Provision for Bad Debts A/c			8,000
To Stock A/c			10,000
To Plant and Machinery A/c (Note 2)			12,000
(Being the balance of Capital Reduction Account used for writing-off debit balance of Profit and Loss Account, patents, investment in shares of subsidiary company, stock, plant and machinery and creating provision for bad debts as per the scheme of reconstruction)			

Teesta Iron Products Limited (and Reduced)
Balance Sheet as at 1st January, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,90,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	2,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(3)	3,50,000
TOTAL		6,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,18,000
(ii) Intangible Assets	(5)	Nil
(iii) Capital Work-in-progress		—
(iv) Intangible Assets under Development		—
(b) Non-current Investments	(6)	60,000
(c) Deferred Tax Assets (Net)	(7)	34,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(8)	1,10,000
(c) Trade Receivables	(9)	72,000
(d) Cash and Cash Equivalents	(10)	1,46,000
(e) Short-term Loans and Advances		—
(f) Other Current Assets		—
TOTAL		6,40,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
3,50,000 Equity Shares of ₹ 1 each	3,50,000
35,000, 9% Cumulative Preference Shares of ₹ 10 each	3,50,000
	7,00,000
Issued and Subscribed Capital :	
90,000 Equity Shares of ₹ 1 each fully paid	90,000

(2) Long-term Borrowings

Particulars	₹
Secured	
2,000, 10% Mortgage Debentures of ₹ 100 each	2,00,000

(3) Trade Payables

Particulars	₹
Trade Creditors	3,50,000

(4) Fixed Assets

Particulars		₹
Tangible		
Freehold Premises		1,00,000
Plant and Machinery	1,30,000	
Less: Written off as per Scheme	12,000	1,18,000
		2,18,000

(5) Intangible Assets

Particulars	₹
Patents	40,000
Less: Written off as per Scheme	40,000
	Nil

(6) Non-Current Investments

Particulars	₹
Shares in subsidiary	1,20,000
Less: Written off as per Scheme	60,000
	60,000

(7) Long-term Loans and Advances

Particulars	₹
Advance to Subsidiary	34,000

(8) Inventories

Particulars	₹
Stock	1,20,000
Less: Written off as per Scheme	10,000
	1,10,000

(9) Trade Receivables

Particulars		₹
Debtors	80,000	
Less: Provision for bad Debts	8,000	72,000

(10) Cash and Cash Equivalents

Particulars	₹
Cash at Bank (W.N. 3)	1,46,000

Working Notes :

(1) Amount paid by the 9% Preference Shareholders = ₹ 80 × 30,000 / 15 = ₹ **1,60,000**.

Dr. (2) Capital Reduction Account Cr.

Date	₹	Date	₹
To Profit and Loss A/c	1,90,000	By 9% Cumulative Preference Share Capital A/c	3,00,000
To Patent A/c	40,000	By Shares Surrendered A/c	20,000
To Investment in Shares of Subsidiary Company A/c	60,000		
To Provision for Bad Debts A/c	8,000		
To Stock A/c	10,000		
To Plant and Machinery A/c (Balancing figure)	12,000		
	3,20,000		3,20,000

Dr. (3) Bank Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Final Call A/c	60,000	By Balance b/d	50,000
To 10% Mortgage Debentures A/c	1,60,000	By Investment in Shares of Subsidiary Company A/c	24,000
		By Balance c/d	1,46,000
	2,20,000		2,20,000

Illustration 27

The Balance Sheet of M/s. Raman Ltd. as at 31st December, 2015 is as follows:

Balance Sheet of M/s. Raman Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 8,000 Equity Shares of ₹ 100 each fully paid		8,00,000
(b) Reserves and Surplus — Profit and Loss Account		(10,70,000)
(c) Money Received against Share Warrants		—

(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities : (a) Long-term borrowings — 8% Debentures (Secured)		14,00,000
(4) Current Liabilities : (a) Short-term Borrowings (b) Trade Payables — Sundry Creditors (c) Other current liabilities : Accrued Interest on Debentures Income tax Payable		— 4,50,000 70,000 10,000
TOTAL		16,60,000
II. ASSETS		
(1) Non-current Assets : (a) Fixed Assets (i) Tangible Assets — Land, Building and Machinery		14,00,000
(2) Current Assets : (a) Current Investments (b) Inventories — Stock (c) Trade Receivables — Sundry Debtors (d) Cash and Cash Equivalents : Cash at Bank Cash in Hand		15,000 1,00,000 40,000 1,03,000 2,000
TOTAL		16,60,000

The fixed assets are heavily overvalued. A scheme of reconstruction was prepared and passed.

The salient points of the scheme are the following :

(1) Each share shall be sub-divided into ten fully paid Equity Shares of ₹ 10 each.

(2) After such sub-division, each shareholder shall surrender to the Company 90% of his holding, for the purpose of re-issue to Debentureholders and Creditors so far as required, and otherwise for cancellation.

(3) Of those surrendered 50,000 Equity Shares of ₹ 10 each shall be converted into 8% Preference Shares of ₹ 10 each fully paid for debentureholders.

(4) The debentureholders' total claim shall be reduced to ₹ 5,00,000. This will be satisfied by the issue of 50,000 Preference Shares of ₹ 10 each fully paid.

(5) The claim of sundry creditors shall be reduced by 80% and the balance shall be satisfied by allotting them Equity Shares of ₹ 10 each, fully paid from the shares surrendered.

(6) Shares surrendered and not re-issued shall be cancelled.

Assuming that the scheme is duly approved by all parties interested and by the Tribunal, draft necessary Journal Entries and Balance Sheet of the company after the scheme has been carried into effect.

[C.A. (Inter) — Adapted]

Solution **In the books of M/s Raman Ltd.**

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2015 Dec 31	Equity Share Capital (₹ 100) A/c Dr. To Equity Share Capital (₹ 10) A/c (Being 8,000 Eq. Sh. of ₹ 100 each fully paid subdivided into 80,000 Equity Sh. of ₹ 10 each fully paid as per Special Resolution no. ... dtd. ... confirmed by the Tribunal *vide* order ... dtd. ...)		8,00,000	 8,00,000
	Equity Share Capital (₹ 10) A/c Dr. To Shares Surrendered A/c (Being 90% of Equity Shares surrendered for conversion or cancellation as per Special Resolution no. ... dated.....)		7,20,000	 7,20,000
	Shares Surrendered A/c Dr. To 8% Preference Share Capital A/c (Being 50,000 Pref. Sh. of ₹ 10 each fully paid issued to debentureholders out of Shares surrendered in persuance of Scheme of Reconstruction)		5,00,000	 5,00,000

Shares Surrendered A/c	Dr.		90,000	
To Equity Share Capital (₹ 10) A/c				90,000
(Being Eq. Sh. issued to Sundry Creditors equal to 20% of their claim as per Reconstruction Scheme)				
8% Debenture A/c	Dr.		14,00,000	
Accrued Interest A/c	Dr.		70,000	
Sundry Creditors A/c	Dr.		4,50,000	
To Capital Reduction A/c				19,20,000
(Being the entire balance of 8% Debentures A/c, accrued Interest A/c and Sundry Creditors A/c transferred to Capital Reduction A/c as per Scheme of Reconstruction)				
Shares Surrendered A/c (Note 1)	Dr.		1,30,000	
To Capital Reduction A/c				1,30,000
(Being the balance of Shares Surrendered A/c transferred to Capital Reduction A/c as per Reconstruction Scheme)				
Capital Reduction A/c (₹ 19,20,000 + ₹ 1,30,000)	Dr.		20,50,000	
To Profit and Loss A/c				10,70,000
To Land, Building and Machinery A/c				9,80,000
(Being the balance Capital Reduction Account used for writting off the debit balance of Profit and Loss Account and writing-down Fixed Assets as per scheme of reconstruction)				

Workings Note :

(1) Total amount of Shares Surrendered is ₹ 7,20,000. ₹. 5,00,000 of the surrendered Shares has been converted into 8% Preference Shares and ₹ 90,000 has been issued to Sundry Creditors. Therefore, the balance of ₹ 1,30,000 is to be transferred to Capital Reduction Account

Tutorial Note : ***It should be noted that the entire amount of debentures, accrued Interest on debentures and Sundry Creditors should be transferred to Capital Reduction Account because the claims of denenturesholders and Creditors have been satisfied by issuing 8% Preference Shares and equity shares out of shares surrendered.***

M/s Raman Ltd (and Reduced)
Balance Sheet as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,70,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities	(2)	10,000
(d) Short-term Provisions		—
TOTAL		6,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	4,20,000
(2) Current Assets :		
(a) Current Investments		15,000
(b) Inventories		1,00,000
(c) Trade Receivables		40,000
(d) Cash and Cash Equivalents	(4)	1,05,000
TOTAL		6,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	***
Issued and Subscribed Capital :	
17,000 Equity Shares of ₹ 10 each fully paid	1,70,000
50,000, 8% Preference Shares of ₹ 10 each	5,00,000
	6,70,000

(2) Other Current Liabilities

Income-tax Payable	10,000

(3) Fixed Assets

Particulars	₹
Tangible Assets :	
Land, Building and Machinery	14,00,000
Less: Written-off as per scheme	9,80,000
	4,20,000

(4) Cash and Cash Equivalent

Cash at Bank	1,03,000
Cash in Hand	2,000
	1,05,000

Scheme for Capital Reduction

For business failure, when large amount of losses accumulate and the book values of the assets show much lower than their fair market values, a Scheme of Capital Reduction is essential, if the recovery of profitability prospects are favourable. In fact, a scheme of capital reduction involves carrying out an internal reconstruction of the company.

When a reduction of capital is proposed, a scheme showing the amount to be reduced from company's capital and the manner in which the reduction is to be applied to the various assets is prepared.

At the time of formulating a scheme of capital reduction, the following points must be kept in mind :

1. The scheme must give an incentive to creditors, debentureholders, lenders and shareholders. Creditors and debentureholders must be convinced that they will be better off by accepting the scheme rather than participating in a liquidation of the company.
2. The scheme must be 'fair' and 'equitable' as between different types of shareholders, creditors, and lenders.
3. Capital reduction scheme is worth considering only if the company has recovery prospects.
4. The scheme must provide for adequate working capital by injecting cash by way of rights issue or loan.

The following steps are followed at the time of formulating a Scheme of Capital Reduction.

Step 1 The first step is to determine the total amount of the losses to be written off. All fictitious assets, e.g., Preliminary Expenses, discount on issue of shares and debentures are to be written-off in addition to the debit balance of Profit and Loss Account. If there is any goodwill in the Balance Sheet, it is also to be written-off. All assets are to be revalued. Loss on Revaluation is to be written-off. Any unprovided liabilities are also to be taken into consideration. Similarly, any profit on revaluation of assets or excess provision of liabilities are to be considered for reduction of total loss.

Step 2 After determining the total amount to be written-off, the next step is to spread the burden of the losses amongst debentureholders, creditors and various classes of shareholders. The main burden of the losses should be borne primarily by the equity shareholders because ultimately they are responsible for all residuary losses. In this respect, the following factors are important:

Secured Creditors: If they are fully secured, then they will not agree to sacrifice anything. The amount not covered by security will be treated as ordinary creditors. Along with the other ordinary creditors they may agree to sacrifice a reasonable amount of their claims.

Debentureholders: They may agree to reduce their claim if they find that the capital reduction scheme is more favourable than the return they may receive on the enforced liquidation of the company. However, the debentureholders may insist an increase in the rate of their interest so that they receive the same amount of interest as received previously.

Unsecured Creditors: They will not agree to sacrifice anything if they are sure that they will get back their entire amount in case of forced liquidation. They may agree to sacrifice some amount if the debentureholders have agreed to a sacrifice, since in a forced liquidiation they would get little or nothing.

Preference Shareholders: They agree to forego arrears of preference dividend with the expectation that the capital reduction scheme would lead to a resumption of their dividends in subsequent years. But so far as the reduction in their capital is concerned, they may not agree to sacrifice any amount if they are sure that they will be paid in full in forced liquidation. When there is a little chance of getting back the entire capital in case of forced liquidation, they may agree to sacrifice some amount of capital. However, they may insist to increase the rate of dividend so that they receive the same amount of dividend as they did previously.

Equity Shareholders: They will have to bear the bulk of the loss. If the amount to be written-off exceeds the equity share capital, they will have to bear the entire loss. In such a situation, the equity shareholders will not be interested to pursue the scheme. In this case preference shareholders and debentureholders must sacrifice some amount to induce to equity shareholders.

Step 3 For successful implementation of the scheme of capital reduction, arrangement of adequate working capital is a must. Any or some of the following sources can provide working capital:

(a) Issue of rights shares.
(b) By reducing the fully paid-up equity shares into partly paid-up and then asking the equity shareholders to make these shares fully paid-up by paying the balance money.
(c) Issue of new debenture to existing debentureholders by offering higher rate of interest.
(d) Issue of commercial paper.

Illustration 28

The Balance Sheet of P Ltd. at 31st March, 2016 was :

Balance Sheet of P Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,00,000
(b) Reserves and Surplus	(2)	(3,00,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		50,000
(b) Trade Payables — Creditors		2,50,000
TOTAL		12,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Land and Building		9,00,000
(b) Non-current investments		2,20,000
(2) Current Assets :		
(b) Inventories		40,000
(c) Trade Receivables — Debtors		39,000
(d) Cash and Cash Equivalents		1,000
TOTAL		12,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000
2,000, 9% Preference Shares of ₹ 100 each	2,00,000
	12,00,000

(2) Reserve and Surplus		
General Reserve		2,25,000
Profit and Loss Account	(6,00,000)	
Less: Current Year's Profit	75,000	(5,25,000)
		(3,00,000)

The market worth of investment was ₹ 2,50,000. The preference share dividend was in arrear for 3 years. Suggest an equitable scheme of internal reconstruction.

Solution

No best solution can be provided for this type of problem. At the time of formulating a scheme of reconstruction, students are to apply their knowledge of the law and accounting principles, to bear in mind the needs of all the interested parties and to state clearly any assumptions made.

Scheme of Capital Reduction

1. First step in formulating a scheme of capital reduction is to calculate the amount of losses to be written-off.

Calculation of Amount to be written-off	₹
Profit and Loss Account (aggregate losses)	5,25,000
Less: General Reserve	2,25,000
	3,00,000
Less: Appreciation in the value of investments	30,000
Total	2,70,000

2. The next step is to spread the burden of the losses amongst equity shareholders and preference shareholders. The main burden of the losses should be borne by the equity shareholders. Therefore, it is suggested that the equity shares be reduced from ₹ 10 to ₹ 7 per share. 1,00,000 equity shares will be writen-off by ₹ 3 per share (1,00,000 x ₹ 3) = ₹ 3,00,000.
   The preference shareholders should not be asked to any sacrifice of their capital. However, they should be induced to sacrifice their arrears of preference divided. To compensate the preference shareholders, the rate of divided should be increased to 10%.
3. The amount sacrificed by the equity shareholders is ₹ 3,00,000. But the amount to be written-off is ₹ 2,70,000. Therefore, ₹ 30,000 will be transferred to Capital Reserve Account.
4. For working capital, it is suggested that the equity shareholders should be asked to contribute ₹ 1 per share to make their share of ₹ 7 to share of ₹ 8. Money collected from equity shareholders will be used to pay-off bank loan which, in effect, will reduce the burden of interest. The balance of ₹ 50,000 will be used as working capital.
5. If the above scheme is accepted, the final Balance Sheet will be as follows :

P Ltd (after Reconstruction)
Balance Sheet as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus	(2)	30,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables		2,50,000
TOTAL		12,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	9,00,000
(b) Non-current Investments	(5)	2,50,000
(2) Current Assets :		
(a) Inventories	(6)	40,000
(b) Trade Receivables	(7)	39,000
(c) Cash and Cash Equivalents	(8)	51,000
TOTAL		12,80,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ₹ ... each	?
	?
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 8 each fully paid	8,00,000
2,000, 10% Preference Shares of ₹ 100 each	2,00,000
	10,00,000
(2) Reserve and surplus	
Capital Reserve	30,000
(3) Trade Payables	
Creditors	2,50,000

(4) Fixed Assets

Particulars	₹
Tangible Assets :	75,000
Land and Building	60,375
(5) Non-Current Investments	2,50,000
(6) Inventories	40,000
(7) Trade Receivables	
Debtors	39,000
(8) Cash and Cash Equivalents	
Cash at Bank	50,000
Cash in Hand	1,000
	51,000

Assumptions :

(i) Fixed assets are not over-valued, i.e., nothing to be written-off.

(ii) Debtors are all good.

(iii)Inventory is valued at the lower of cost or market price.

Illustration 29

The Balance Sheet of N.T.C. Ltd. as at 31st March, 2016 is as follows :

Balance Sheet of N.T.C. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus — Profit and Loss		(1,10,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 9% Debentures		1,00,000
(4) Current Liabilities :		
(a) Trade Payables — Trade Creditors		64,000
(b) Accruals		12,000
TOTAL		5,66,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Freehold Land and Building		1,35,000
Plant and Machinery		85,000
(ii) Intangible Assets		
Goodwill		1,00,000
Patents		80,000
(2) Current Assets :		
(a) Inventories		79,900
(b) Trade Receivables — Debtors		1,10,000
(c) Cash and Cash Equivalents	(2)	(23,900)
TOTAL		5,66,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
25,000 Equity Shares of ₹ 10 each fully paid	2,50,000
25,000, 6% Preference Shares of ₹ 10 each fully paid	2,50,000
	5,00,000
(2) Cash and Cash Equivalents	
Bank Overdraft	(24,000)
Cash in Hand	100
	(23,900)

Additional Information :

1. Dividends on the preference shares are five years in arrears, and accruals represent two years' arrears of debenture interest.
2. Current trading results show marked improvement and the anticipated profit of next year ₹ 24,000, after debenture interest of ₹ 6,000 has been charged. It is expected that profits after that will show substantial improvements year by year (present estimates are 10% increase per annum).
3. The resumption in the payment of dividends as soon as possible is desired and accordingly the directors are considering the reduction of the company's capital.
4. The debentureholders have expressed their willingness to exchange their arrears of interest for equity in the business equal to half the nominal value of arrears and to provide ₹ 25,000 (on floating charge) to pay the bank overdraft and to provide working capital of ₹ 1,000.
5. The preference shareholders have expressed their willingness to a reduction in the rate of dividend to 5% and to forego 2/3 of their arrears, provided they receive an interest in the equity equal in nominal value from the remaining 1/3.

You are required :

(a) To draft a suggested scheme for the reduction in capital which should include the elimination of goodwill and the Profit and Loss Account balance, the value of the patent is ₹ 50,000 and the provision of a capital reserve through which any adjustments arising out of capital rearrangements etc., may be dealt. After reduction the equity shares are to be converted into ₹ 1 per share.

(b) To draft the Balance Sheet after the implementation of the scheme.

Solution

Scheme of Capital Reduction

1. First step in formulating a scheme of capital reduction is to calculate the amount of the losses, including reduction in the value of assets which have to be written-off.

Calculation of Amount to be written-off	₹
Profit and Loss Account (Total)	1,10,000
Goodwill	1,00,000
Patents	50,000
Arrear of Preference dividend (1/3rd)	25,000
	2,85,000
Less: Debenture interest foregone	6,000
Total	2,79,000

2. The next step is to spread the burden of the losses amongst equity shareholder and preference shareholders. The main burden of the losses should be borne primarily by the equity shareholders. Therefore, it is suggested that the equity shares be reduced from ₹ 10 to Re 1 per share. 25,000 equity shares will be written-down to Re 1 per share (25,000 x ₹ 9) = ₹ 2,25,000.
   It is suggested that the preference shares be reduced from ₹ 10 to ₹ 7 per share. 23,000 preference share will be written-down, i.e., (25,000 x ₹ 3) = ₹ 75,000.
3. Total amount sacrificed by the shareholders = ₹ 2,25,000 + ₹ 75,000 = ₹ 3,00,000.
4. Amount to be written-off is ₹ 2,79,000. Therefore, amount to be transferred to Capital Reserve (₹ 3,00,000 – ₹ 2,79,000) = ₹ 21,000.
5. For 1/2 of the arrears of debenture, i.e., ₹ 6,000, the present debentureholders will require 6,000 equity shares of Re 1 each.

6. The present preference shareholders will require equity shares of ₹ 25,000 which is equal to 1/3 of their arrears of dividend.
7. The present preference shareholders will also have 25,000, ₹ 10 preference shares reduced to ₹ 7 per share = ₹ 1,75,000. Some of these preference shares could then be converted into equity shares to give them control in the reconstructed company, also to give the company some gearing and to maintain a reasonable allocation of dividend. It is suggested that the conversion should be to the extent of ₹ 35,000, i.e., 35,000 equity shares of ₹ 1 each.
8. If the above scheme is accepted then disposal of the anticipated profit will be as follows : (₹)

	(₹)
Profit	24,000
Less : Interest on new debentures @ 6% on ₹ 25,000	1,500
	22,500
Less: Tax*	Nil
	22,500
Less: Transferred to reserve (say 5%)	1,125
	21,375
Less: Preference dividend @ 5% on ₹ 1,40,000	7,000
Profit available to equity shareholders	14,375

$$\text{Expected Rate of Dividend} = \frac{14,375}{91,000} \times 100 = 15.80\%$$

* No income tax is payable by the company in the next few years because it will enjoy the benefit to adjust profit against carry forward losses.

N.T.C. Ltd (after Reconstruction)
Balance Sheet as at . . .

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,31,000
(b) Reserves and Surplus	(2)	21,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	1,25,000
(4) Current Liabilities :		
(a) Trade Payables	(4)	64,000
TOTAL		4,41,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,20,000
(ii) Intangible Assets	(6)	30,000
(2) Current Assets :		
(a) Inventories	(7)	79,900
(b) Trade Receivables	(8)	1,10,000
(c) Cash and Cash Equivalents	(9)	1,100
TOTAL		4,41,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ₹ ... each	?
... Preference Shares of ₹ ... each	?
	?

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Freehold Land and Building	1,35,000
Plant and Machinery	85,000
	2,20,000

Issued and Subscribed Capital :		**(6) Intangible Assets**			
91,000 Equity Shares of ₹ 1 each fully paid	91,000	Patents		80,000	
20,000, 5% Preference Shares of ₹ 7 each	1,40,000	Less: Written off		50,000	30,000
	2,31,000	**(7) Inventories**			79,900
(2) Reserve and Surplus					
Capital Reserve	21,000	**(8) Trade Receivables**			
(3) Long-term Borrowings		Debtors			1,10,000
6% Debentures (including new)	1,25,000	**(9) Cash and Cash Equivalents**			
(4) Trade Payables		Cash at Bank (W.N. 1)		1,000	
Trade Creditors	64,000	Cash in Hand		100	1,100

Working Note:

(1) New debentures will be issued for ₹ 25,000. Bank overdraft will be paid-off. Therefore, cash at bank will be ₹ 1,000.

KEY POINTS

- Capital Reduction is the repayment or writing down of a company's different classes of capital, as a result of large accumulated losses or an excess of funds without profitable use.
- The objective of Capital Reduction is the resumption of the payment of normal dividends out of the expected future profits without the necessity of using those profits to write-off the debit balance of the Profit and Loss Account.
- In order to effect Share Capital Reduction, the following formalities must be completed in accordance with the Companies Act, 2013.
  - (i) The company must be authorised by its articles of association to reduce the share capital. If there is no provision in the article in this respect, it must pass a Special Resolution to alter its articles of association. It should be noted that an authority to do so contained in the memorandum is of no avail. (Re: Dexine Patent Packing and Rubber Co.)
  - (ii) The company must pass a Special Resolution to reduce the share capital.
  - (iii) The company must apply, by petitions, to the Tribunal for an order confirming the reducion.If theTribunal is satisfied that the debt or claim of every creditor of the Company has been discharged or determined or has been secured or his consent is obtained, it may confirm the Capital Reduction.
    However it may impose terms and conditions as it deems fit.
  - (iv) The company has to deliver to the Registrar a certified copy of the Tribunal's order and a minute approved by the Tribunal showing the details of the shares for registration.
  - (v) The Registrar will then register the order and the minute.
  - (vi) After registration of these, the Resolution to reduce the share capital shall take effect.
  - (vii) Notice of the registration shall be published in such a manner as the Tribunal may direct.
- **The reduction of capital may take any of the following forms** :
  - (i) The company may reduce the liability of the shareholders in respect of any unpaid amount on the shares held by them.
  - (ii) The company may pay-off any paid-up share capital which is in excess of its requirements.
  - (iii) The company may cancel any paid-up share capital which is lost or unrepresented by available assets.
- At the time of preparing Balance Sheet after reconstruction is duly carried out, the following matters should be taken into consideration.
  1. If the Tribunal orders, the words "and reduced" should be added after the name of the company for certain period.
  2. In respect of fixed assets, the amount written-off under a scheme of reconstruction must be shown for five years.
- At the time of formulating a scheme of capital reduction, the following points must be kept in mind :
  1. The scheme must give an incentive to creditors, debentureholders, lenders and shareholders. Creditors and debenture-holders must be convinced that they will be better off by accepting the scheme rather than participating in a liquidation of the company.
  2. The scheme must be 'fair' and 'equitable' as between different types of shareholders, creditors, and lenders.
  3. Capital reduction scheme is worth considering only if the company has recovery prospects.
  4. The scheme must provide for adequate working capital by injecting cash by way of rights issue or loan.

THEORETICAL QUESTIONS

1. What do you mean by Capital Reduction ?
2. State the procedures for Capital Reduction.
3. What are the steps to be followed at the time of formulating a scheme of capital reduction ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. The company must pass
   A a members resolution to reduce the share capital
   B an ordinary resolution to reduce the share capital
   C a special resolution to reduce the share capital.
2. Capital reduction must be authorised by its
   A articles of association
   B memorandum of association
   C none of the above.
3. Capital reduction scheme is worth considering
   A if the company is small
   B if the company has recovery prospects
   C if the company has no prospects.
4. The company must apply for an order confirming the reduction
   A to the Supreme Court
   B to the High Court
   C to the Tribunal
5. The company has to deliver to the Registrar for registration :
   A a certified copyt of the Tribunal's order
   B a minute approved by the Tribunal showing the details of the shares
   C a certified copy of the Tribunal's order and a minute approved by the Tribunal showing the details of the shares

PRACTICAL QUESTIONS

1. Following a series of trading losses, Failure Ltd. resolved to reduce its capital to 50,000, Equity Shares of ₹ 4 each, fully paid and to eliminate its Securities Premium Account. The Company's Balance Sheet prior to implementation of new scheme was :

Balance Sheet of Failure Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 50,000 Equity Shares of ₹ 10 each		5,00,000
(b) Reserves and Surplus — Securities Premium Reserve		50,000
Profit and Loss Account		(95,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		97,000
(b) Trade Payables — Creditors		1,62,000
TOTAL		7,14,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		1,52,000
Plant and Machinery		2,78,000
(ii) Intangible Assets — Goodwill		1,20,000
(2) Current Assets :		
(a) Inventories		90,000
(b) Trade Receivables — Debtors		74,000
TOTAL		7,14,000

It was resolved to apply the sum available under the scheme :

(a) to write-off Goodwill and debit balance of Profit and Loss Account.

(b) to reduce the value of Assets by :
Inventories ₹ 10,000; Land and Building ₹ 36,000; and Plant and Machinery ₹ 78,000.

(c) to write-off ₹ 4,000 bad debt and to provide 10% of remaining debtors as provision for doubtful debts.

Show Journal Entries to implement the scheme and show the Balance Sheet of the Company after reconstruction.

2. Give Journal Entries for the following transactions in connection with internal reconstruction :

(i) 10,000 Equity Shares of ₹ 10 each fully paid, reduced to shares of ₹ 5 each fully paid.

(ii) 100, 8% Debentures ₹ 1,000 each converted into 500, 6% Debentures of ₹ 100 each.

(iii) The debit balance of Profit and Loss Account, ₹ 50,000 and the preliminary expenses of ₹ 10,000 were written-off.

(iv) The value of Plant and Machinery and Stock were written-down by ₹ 20,000 and ₹ 10,000 respectively.

3. The summarised Balance Sheet of Siliguri Transport Co. Ltd. as on 31st March, 2016 was as follows :

Balance Sheet of Siliguri Transport Co. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 20,000 Equity Shares of ₹ 10 each		2,00,000
(b) Reserves and Surplus — Profit and Loss Account		(80,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 1,000, 5% Debentures of ₹ 100 each		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		30,000
Bills Payable		10,000
TOTAL		2,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		70,000
Plant and Machinery		85,000
Furniture and Fixtures		8,000
(ii) Intangible Assets — Goodwill		20,000
(2) Current Assets :		
(a) Inventories		35,000
(b) Trade Receivables — Sundry Debtors		40,000
(c) Cash and Cash Equivalents — Cash at Bank		2,000
TOTAL		2,60,000

A scheme of capital reduction was duly approved and adopted.

The Equity Shares were reduced to the same number of shares each of ₹ 5 and 5% Debentures converted into the same number of 6% Debentures of ₹ 75 each.

The amount thus realised was utilised to write-off the debit balances of Profit and Loss Account and Goodwill Account, to reduce Plant and Machinery by ₹ 13,000; Furniture and Fixtures by ₹ 2,000; Stock by ₹ 6,000 and to create a Provision for Sundry Debtors at 10%.

Show the necessary Journal Entries to give effect to the scheme of reconstruction and a Balance Sheet after reconstruction.

4. A public limited company passed the necessary Resolution and received sanction of the Tribunal for the reduction of its share capital by ₹ 5,00,000 for the purposes enumerated hereunder :

(a) To write-off the debit balance of Profit and Loss Account of ₹ 2,10,000;

(b) To reduce the value of plant and machinery by ₹ 90,000 and of goodwill by ₹ 40,000;

(c) To reduce the value of investment to market value by writing-off ₹ 80,000.

The reduction was made by converting 50,000 preference shares of ₹ 20 each fully paid to the same number of preference shares of ₹ 15 each fully paid, and by converting 50,000 ordinary shares of ₹ 20 each, ₹ 15 paid-up into 50,000 ordinary shares of ₹ 10 each fully paid.

Give Journal Entries necessary in relation to the reduction of share capital and show how you would deal with the balance of the reduction of Share Capital Account.

5. The Balance Sheet of Swan Ltd. as on 31.3.2016 was as follows :

Balance Sheet of Swan Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,50,000
(b) Reserves and Surplus — Profit and Loss Account		(1,45,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		20,000
(b) Trade Payables — Sundry Creditors		30,000
TOTAL		11,55,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Leasehold Premises		1,30,800
Plant and Machinery		42,000
(ii) Intangible Assets — Patents at Cost		8,50,000
(2) Current Assets :		
(a) Inventories		56,500
(b) Trade Receivables — Debtors		75,200
(c) Cash and Cash Equivalents — Cash at Bank		500
TOTAL		11,55,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 100 each fully paid	10,00,000
10,000 Preference Shares of ₹ 100 each	10,00,000
	20,00,000

Issued, Subscribed and Paid-up Capital :	
5,000 Equity Shares of ₹ 10 each fully paid	5,00,000
7,500 Preference Shares of ₹ 100 each fully paid	7,50,000
	12,50,000

The following scheme of reconstruction was adopted :

(a) The preference shares be reduced to an equal number of fully paid shares of ₹ 50 each.

(b) The equity shares be reduced to 25% of their present values.

(c) The amount available be used to write-off ₹ 30,800 from leasehold premises, ₹ 15,000 from stock, 20% off plant and machinery and sundry debtors. The balance available will be utilised in writing-off patents after the remaining intangible assets are written-off in full.

Journalise the transactions in the books of the Company and prepare the Balance Sheet after the reconstruction.

6. Below is given the Balance Sheet of D. Ltd. as at 31.3.2016.

Balance Sheet of D Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus — Profit and Loss Account		(1,74,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		35,000
(b) Trade Payables — Sundry Creditors		40,000
TOTAL		7,01,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Leasehold Premises		4,50,000
Plant		80,000
(2) Current Assets :		
(a) Current Investments		
(b) Inventories		70,000
(c) Trade Receivables — Sundry Debtors		1,00,000
(d) Cash and Cash Equivalents — Cash at Bank		1,000
TOTAL		7,01,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
10,000 Equity Shares of ₹ 50 each fully paid	5,00,000
10,000 Preference Shares of ₹ 50 each	5,00,000
	10,00,000

Issued, Subscribed and Paid-up Capital :	
8,000 Equity Shares of ₹ 50 each fully paid	4,00,000
8,000 Preference Shares of ₹ 100 each fully paid	4,00,000
	8,00,000

Due to heavy losses the company decided upon the following scheme of reconstruction :

(i) The preference shares were to be reduced to a value of ₹ 30 each. The equity shares also were to be reduced to the value of ₹ 30 each;

(ii) The balance available was to be used to write-off the debit balance of the Profit and Loss Account; ₹20,000 from Inventories; a provision of ₹ 30,000 was to be made against the Sundry Debtors.

The leasehold premises were to be reduced by ₹ 66,000 and the Plant Account was to be reduced to ₹ 50,000. You are required to journalise the above transactions and prepare the reconstructed Balance Sheet.

7. Following was the Balance Sheet of B Ltd. as on 31.3.2016 :

Balance Sheet of B Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	11,00,000
(b) Reserves and Surplus — Profit and Loss		(2,30,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Secured Loan		50,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		1,05,000
(b) Trade Payables — Sundry Creditors		1,25,000
TOTAL		11,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		4,50,000
Plant and Machinery		2,50,000
(ii) Intangible Assets — Goodwill		1,50,000
Patents		45,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,35,000
(c) Trade Receivables — Debtors		90,000
(d) Cash and Cash Equivalents — Cash at Bank		30,000
TOTAL		11,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
8,000 Equity Shares of ₹ 100 each fully paid	8,00,000
3,000, 5% Preference Shares of ₹ 100 each fully paid	3,00,000
	11,00,000

The company undertook following scheme of reconstruction :

(a) Equity shares were to be reduced to shares of ₹ 50 each fully paid.
(b) Preference shares were to be converted into 7% Preference shares of ₹ 70 each fully paid.
(c) Sundry creditors agreed to give up 1/5th of their claims provided they are paid-off immediately.
(d) 5,000 Equity shares of ₹ 50 each were to be issued for cash.
(e) Expenses on reconstruction were to be ₹ 7,500.
(f) The company decided — (i) to write-off Goodwill, Profit and Loss Account, Patents; (ii) to write-down Plant and Machinery by ₹ 45,000 and Inventories by ₹ 20,000; (iii) to create a provision for doubtful debts @ 5%.

Give Journal Entries and prepare Balance Sheet giving effect to the scheme of reconstruction.

8. The following was the Balance Sheet of Tin Toys Ltd. as on 31st March, 2016 :

Balance Sheet of Tin Toy Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,11,000
(b) Reserves and Surplus — Profit and Loss		(22,300)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		15,425
(c) Other Provisions — Provision for Tax		4,000
TOTAL		1,08,125
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Buildings		20,500
Machinery		50,850
(ii) Intangible Assets — Goodwill		10,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		10,275
(c) Trade Receivables — Sundry Debtors		15,000
(d) Cash and Cash Equivalents — Cash at Bank		1,500
TOTAL		1,08,125

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000
Issued, Subscribed and Paid-up Capital :	
12,000 Equity Shares of ₹ 10 each	1,20,000
Less: Calls-in-Arrear (₹ 3 per share on 3,000 shares)	9,000
	1,11,000

The directors find that the machinery is overvalued by ₹ 10,000. It is now proposed to write-down this asset to its true value and extinguish Goodwill Account, Profit and Loss Account by adopting the following scheme : (a) Forfeit the shares on which the calls are outstanding; (b) Reduce the paid-up capital by ₹ 3 per share; (c) Reissue the forfeited shares at ₹ 5 per share; (d) Utilise the provision for taxes, if necessary.

Draft the Journal Entries necessary for giving effect to the above scheme and prepare the reconstructed Balance Sheet of the company.

9. The ledger balances of X Co. Ltd as on 31.3.2016 was as follows :
Fixed Assets ₹ 7,00,000; Investments ₹ 10,000; Stock and Debtors ₹ 8,50,000; Preliminary Expenses ₹ 20,000; Equity Share Capital (60% paid) ₹ 6,00,000; 10% First Debentures ₹ 2,00,000; 12% Second Debentures ₹ 5,00,000; Bank Overdraft ₹ 50,000; Trade Creditors (including Y for ₹ 8,50,000) ₹ 11,50,000; Outstanding Interest for one year on both types of debentures ₹ 80,000. Due to heavy losses, the following scheme of reconstruction was agreed:
(i) to make the existing ₹ 100 equity shares fully paid-up and then reduce them to ₹ 20 each.
(ii) to settle the claims of first debentureholders by issuing 2,000, 13.5% debentures of ₹ 100 each.
(iii) to discharge the claims of the second debentureholders by issuing 15%, 4,000 debentures of ₹ 100 each.
(iv) to pay ₹ 3,00,000 to Y in full settlement of his account.
(v) to allot 15,000 fresh equity shares of ₹ 20 each to discharge the remaining trade creditors.
(vi) market value of investments ₹ 20,000.
(vi) to write-off the fictitious assets and to reduce the fixed assets.
Pass journal entries to give effect to the above and prepare post-reconstruction Balance Sheet.

10. Following is the Balance Sheet of Eknath & Co. Ltd. as on 31.3.2016 :

Balance Sheet of Eknath Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus — Profit and Loss Account		(4,10,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		1,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		1,50,000
(c) Other current liabilities — Interest due on Debentures		10,000
TOTAL		3,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		75,000
Plant and Machinery		90,000
(ii) Intangible Assets — Goodwill		80,000
Patents and Trademarks		20,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories at Cost		40,000
(c) Trade Receivables — Sundry Debtors		39,000
(d) Cash and Cash Equivalents — Cash at Bank		6,000
TOTAL		3,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
5,000 Equity Shares of ₹ 100 each fully paid	5,00,000
5,000, 6% Preference Shares of ₹ 100 each	5,00,000
	10,00,000

Issued, Subscribed and Paid-up Capital :	
3,000 Equity Shares of ₹ 100 each fully paid	3,00,000
2,000, 6% Preference Shares of ₹ 100 each fully paid	2,00,000
	5,00,000

It is believed that the worst is over and that the time has arrived to effect reconstruction. A revaluation of assets reveals the following :

Land and Buildings ₹ 95,000; Plant and Machinery ₹ 1,12,000; Patents and Trademarks ₹ 5,000; Inventories ₹ 25,000; Debtors ₹ 32,000.

The following scheme is framed and approved by the Tribunal :

(1) The preference shares be converted into 7.5% preference shares of ₹ 30 each fully paid.
(2) The equity shares be converted into shares of ₹ 5 each fully paid.
(3) The sundry creditors be given the option to either accept 50% of their claims in cash in full satisfaction or to convert their claims into equity shares of ₹ 5 each.
(4) The revaluation of assets be adopted.

One-third (in value) of the creditors accepted equity shares for their claims. The rent was paid cash which was raised by issuing 17,000 fully paid equity shares to the existing equity shareholders. All shares including preference shares were then consolidated (or sub-divided) into equity shares of ₹ 10 each. In view of the unsatisfactory state of affairs of the company the debentureholders agreed to forego the interest due on debentures.

Pass journal entries and prepare the Balance Sheet, after the scheme is put into effect.

11. The Balance Sheet of X Ltd. before reconstruction is as follows :

Balance Sheet of X Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	13,50,000
(b) Reserves and Surplus — Profit and Loss Account		(4,51,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Loans		5,73,000
(4) Current Liabilities :		
(a) Short-term Borrowings		
(b) Trade Payables — Creditors		2,07,000
(c) Other current liabilities		35,000
TOTAL		17,14,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Buildings at Cost less depreciation		4,00,000
Plant and Machinery less depreciation		2,68,000
(ii) Intangible Assets — Goodwill		3,18,000
(2) Current Assets :		
(a) Inventories		4,00,000
(b) Trade Receivables — Debtors		3,28,000
TOTAL		17,14,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
15,000 Equity Shares of ₹ 50 each fully paid	7,50,000
12,000, 7% Preference Shares of ₹ 50 each fully paid	6,00,000
	13,50,000

Note : Preference dividend is in arrear for five years.

The company is now earning profits but is short of working capital. A reconstruction scheme has, therefore, been approved which is as follows :

(1) Equity shareholders have agreed that their ₹ 50 shares be reduced to ₹ 2.50 per share and they have agreed to subscribe in cash for 3 equity shares of ₹ 2.50 each for every equity share held.

(2) Preference shareholders have agreed to cancel the arrears of preference dividend and to accept for each ₹ 50 preference share, 4 new 5% preference shares of ₹ 10 each plus 6 new equity shares of ₹ 2.50 each, all credited as fully paid.

(3) Lenders to the company of ₹ 1,50,000 have agreed to convert their loan into shares and, for their purpose, they will be allotted 12,000 new 5% preference shares of ₹ 10 each and 12,000 new equity shares of ₹ 2.50 each, are credited as fully paid.

(4) The directors have agreed to subscribe in cash for 40,000 new equity shares of ₹ 2.50 each in addition to any shares to be subscribed for by them under (1) above.

(5) Of the cash received, ₹ 2,00,000 is to be used to reduce loans due by the company.

(6) Authorised capital is to be increased to the old figure of ₹ 6,00,000 for preference capital and ₹ 7,50,000 for equity capital.

(7) The equity share capital cancelled is to be applied to write-off debit balance on Profit and Loss Account, to reduce ₹ 35,000 from the value of plant and any balance remaining to be used to write-down the value of goodwill.

Pass journal entries and re-draft the Balance Sheet.

12. The Balance Sheet of P Ltd., as on 31st March, 2016 is as stated below :

Balance Sheet of P Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,50,000
(b) Reserves and Surplus — Profit and Loss Account		(1,50,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		1,00,000
(b) Trade Payables — Sundry Creditors		60,000
Bills Payable		50,000
TOTAL		8,10,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		2,70,000
Plant and Machinery		2,40,000
(ii) Intangible Assets :		
Goodwill		42,300
Patents		18,000

(2) Current Assets :		
(a) Inventories		88,800
(b) Trade Receivables — Debtors		1,50,900
TOTAL		8,10,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
45,000 Equity Shares of ₹ 10 each fully paid	4,50,000
3,000, 6% Preference Shares of ₹ 100 each fully paid	3,00,000
	7,50,000

Dividends on preference shares are in arrear for three years.

The company passes a Special Resolution to reduce its capital in accordance with the following scheme and the same is duly sanctioned by the Tribunal :

(a) The Preference Shares are converted from 6% to 8%, but revalued in a manner in which the total return on them remains unaffected. The value of Equity Shares is brought down to ₹ 8 per share.

(b) The arrears of dividend on Preference Shares are cancelled.

(c) The debit balance of the Goodwill Account is written-off entirely.

(d) Land and Building and Plant and Machinery are revalued at 85% and 80% of their respective book values.

(e) Book debts to the amount of ₹ 7,200 are treated as bad and hence, to be written-off.

(f) The company expects to earn profit @ ₹ 45,000 per annum from the current year which would be utilised entirely for reducing the debit balance of the Profit and Loss Account for three years. The remaining balance of the said account would be written-off at the time of capital reduction process.

(g) The balance of total capital reduction is to be utilised in writing-down patents.

(h) A secured loan of ₹ 2,40,000 bearing interest at 12% p.a. is to be obtained by mortgaging tangible fixed assets for procuring cash for repayment of bank overdraft and for providing additional funds for working capital.

Journalise the above scheme and draw a Balance Sheet after the implementation is over.

13. The following is the Balance Sheet of Sick Ltd. as on 31.3.2016 :

Balance Sheet of Sick Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus — Profit and Loss Account		(3,00,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6% Debentures		3,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		
(b) Trade Payables — Sundry Creditors		39,00,000
(c) Short-term provisions — Provision for Tax		3,00,000
TOTAL		50,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		15,00,000
(2) Current Assets :		
(a) Other Current Assets		35,00,000
TOTAL		50,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
70,000 Equity Shares of ₹ 10 each fully paid	7,00,000
1,000, 13% Cumulative Preference Shares of ₹ 100 each fully paid	1,00,000
	8,00,000

The following scheme of reorganisation is sanctioned :

(1) Tangible fixed assets are to be written-down by $33^1/_3$%.

(2) Current assets are to be revalued at ₹ 27,00,000.

(3) Preference shareholders decide to forego their right to arrears of dividend which are in arrears for three years.

(4) The taxation liability of the company is settled at ₹ 4,00,000.

(5) One of the creditors of the company, to whom the company owes ₹ 25,00,000, decides to forego 50% of his claim. He is allotted 1,00,000 Equity Shares of ₹ 5 each in part satisfaction of the balance of his claim.

(6) The rate of interest on debentures is increased to 11%. The debentureholders surrender their existing debentures of ₹ 100 each and exchange the same for fresh Debentures of ₹ 75 each.

(7) All existing Equity Shares are reduced to ₹ 5 each. (8) All Preference Shares are reduced to ₹ 75 each.

Pass Journal Entries and show the Balance Sheet of the company after giving effect to the above.

14. Given below is the Balance Sheet of Be-Kismat Ltd. as at 31st March, 2016 :

Balance Sheet Be-Kismat Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,50,000
(b) Reserves and Surplus — Profit and Loss Account		(6,00,000)
Development Reserve		1,50,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Loan (Unsecured)		6,40,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors (including ₹ 10,000 holding lien on some assets)		2,60,000
TOTAL		9,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		1,00,000
Machinery		4,00,000
Motor Vans		40,000
Furniture		10,000
(b) Non-current investments — (Market value ₹ 40,000)		50,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,00,000
(c) Trade Receivables — Debtors		1,90,000
(d) Cash and Cash Equivalents — Cash at Bank		10,000
TOTAL		9,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
4,000 Equity Shares of ₹ 100 each	4,00,000
1,000 Equity 'A' Shares of ₹ 100 each, ₹ 50 per share paid	50,000
	4,50,000

The company having turned to the corner, a scheme of reconstruction was prepared and approved as under :

(1) To bring in the books the present market value of land and buildings which had appreciated by 150%;

(2) Equity shares to be reduced to ₹ 10 per share paid by cancelling ₹ 90 per share, the face value remaining the same at ₹ 100 and the equity shareholders paying a call of ₹ 50 per share to provide funds for the company's working;

(3) Unsecured loans to be paid immediately to the extent of ₹ 1,00,000;

(4) Unsecured creditors to be paid immediately to the extent of 10% of their claims and they accepting a remission of 20% of their claims;

(5) Development rebate reserve, being no longer required, to be transferred to Profit and Loss Account;

(6) Investments to be brought to their market value; and

(7) The amount available as a result of the scheme to be used to write-off the debit balance in Profit and Loss Account.

Give Journal Entries to record the above and give the Balance Sheet after the reconstruction is effected.

[B.U. B.Com. — Adapted]

15. The following is the summarised Balance Sheet of AB Ltd. as on 31st March, 2016 :

Balance Sheet of AB Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	9,00,000
(b) Reserves and Surplus — Profit and Loss Account		(3,24,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 8% Debentures (Secured on Land and Buildings		1,20,000
Directors' Loan		1,65,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan (Secured on Inventories)		75,000
(b) Trade Payables — Creditors		2,70,000
(c) Other Current Liabilities — Accrued interest on Debentures		6,000
TOTAL		12,12,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Building		2,67,000
Plant		2,55,000
(ii) Intangible Assets — Goodwill		1,20,000
(b) Non-current investments — Shares in Subsidiary (at Cost)		75,000
(2) Current Assets :		
(a) Current Investments		
(b) Inventories		2,25,000
(c) Trade Receivables — Debtors		2,70,000
(d) Cash and Cash Equivalents		—
TOTAL		12,12,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
6,00,000 Equity Shares of ₹ 1 each fully paid	6,00,000
30,000, 6% Preference Shares of ₹ 10 each	3,00,000
	9,00,000
Issued, Subscribed and Paid-up Capital :	
6,00,000 Equity Shares of ₹ 10 each fully paid	6,00,000
30,000, 6% Preference Shares of ₹ 100 each fully paid	3,00,000
	9,00,000

Notes : (a) There is a contingent liability of ₹ 30,000. (b) Preference shares are cumulative and dividends are in arrear for three years.

A capital reduction scheme stating the following terms was duly approved :

(i) The preference shares to be reduced to ₹ 8 per share and the equity shares to 25 paise each and to be consolidated as shares of ₹ 10 each and Re 1 each fully paid respectively. The preference shareholders waive two-thirds of dividend arrear and receive equity shares for the balance. The authorised capital to be restored to ₹ 30,000 preference shares of ₹ 10 each and 6,00,000 equity shares of Re 1 each. (ii) The shares in Subsidiary Ltd. are sold to an outside interest for ₹ 1,50,000. (iii) All intangible assets are to be eliminated and bad debts of ₹ 12,000 and obsolete stock of ₹ 30,000 to be written off. (iv) The debentureholders to take over one of company's properties (book value ₹ 54,000) at a price of ₹ 60,000 in part satisfaction of the debentures and to provide further cash of ₹ 45,000 on a floating charge. The arrears of interest are paid. (v) The contingent liability materialised in the sum stated but the company recovered ₹ 15,000 of these damages in action against one of its directors. This was debited to his loan account of ₹ 24,000, the balance of which was paid in cash on his resignation. (vi) The remaining directors agreed to take equity shares in satisfaction of their loans.

You are required to :

(i) give the necessary Journal Entries including cash transactions; and

(ii) set out the revised Balance Sheet after giving effect to the foregoing entries. ***[I.C.W.A.(Inter) — Adapted]***

16. The Balance Sheet of Tripathi Ltd. dated 31.3.2016 is as follows :

Balance Sheet of Tripathi Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 40,000 Equity Shares of ₹ 100 each fully paid		4,00,000
(b) Reserves and Surplus — Profit and Loss Account		(5,35,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		6,70,000
(4) Current Liabilities :		
(a) Short-term Borrowings		
(b) Trade Payables — Sundry Creditors		2,25,000
(c) Other current liabilities — Income tax		5,000
Interest accrued on Debentures		20,000
TOTAL		7,85,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Land and Buildings		7,15,000
(ii) Intangible Assets		

(2) Current Assets :		
(a) Current Investments		8,500
(b) Inventories		40,000
(c) Trade Receivables — Sundry Debtors		15,000
(d) Cash and Cash Equivalents — Cash at Bank		6,500
TOTAL		7,85,000

The fixed Assets are much over-valued. The Debentureholders are prepared to accept modification of their claims in consideration of a substantial interest in Share Capital. A scheme of reconstruction is accordingly prepared as follows:

(i) Each equity share shall be sub-divided into twenty fully paid equity shares of ₹ 5 each.

(ii) After sub-division each shareholder shall surrender to the company 95% of the holding for the purpose of re-issue to Debentureholders and Creditors, so far as required and otherwise for cancellation.

(iii) The Debentureholders' total claims shall be reduced to ₹ 1,15,000 in consideration for which the Debentureholders shall receive from the company 23,000 equity shares of ₹ 5 each in full satisfaction of their claims.

(iv) The claims of creditors of ₹ 2,25,000 shall be reduced by 4/5th of the amount and the balance shall be satisified by allotting them equity shares of ₹ 5 each from the shares surrendered.

(v) Shares surrendered and not re-issued shall be cancelled.

Journalise the transactions and prepare a Balance Sheet showing the effect of the scheme.

17. Abridged Balance Sheet of Z Ltd as on 31.3.2016 is as under :

Balance Sheet Z Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	40,00,000
(b) Reserves and Surplus — Profit and Loss Account		(15,50,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 15% Debentures		10,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		
(b) Trade Payables — Sundry Creditors		8,40,000
(c) Other current liabilities — Interest due on Debentures		3,00,000
TOTAL		45,90,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		30,00,000
(ii) Intangible Assets — Goodwill		5,00,000
(2) Current Assets :		
(a) Other current assets		10,90,000
TOTAL		45,90,000

Following scheme of reconstruction has been passed and approved by the Tribunal :

(i) The equity shares are to be subdivided into shares of ₹ 10 each, and each shareholder shall surrender 70% of his holdings.

(ii) Out of the surrendered shares, 50,000 shares shall be issued to preference shareholders in full settlement of their claims.

(iii) Debentureholders' total claim shall be reduced to ₹ 7,00,000 and shall be satisfied by issue of 70,000 equity shares, out of surrendered shares.

(iv) Creditors' claim are to be reduced by 50% and in consideration the creditors shall receive 20,000 equity shares out of the surrendered shares.

(v) The remaining surrendered shares shall be cancelled.

(vi) Goodwill and Profit and Loss Account are to be written off completely and tangible fixed assets are to be depreciated by ₹ 10,00,000.

You are required to prepare journal entires in the books of Z Ltd and a Balance Sheet after effecting the scheme.

18. The Directors of Hardluck Ltd. decided to recommend to the shareholders certain steps to put the affairs of the company back on the rails. On 31st March, 2016 the Balance Sheet of the company was as under :

Balance Sheet as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	85,000
(b) Reserves and Surplus — Profit and Loss		(68,300)
Securities Premium		15,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Loan from Directors		60,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		56,500
(b) Trade Payables — Sundry Creditors		64,500
TOTAL		2,12,700
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Freehold Property at Cost		41,500
Plant and Machinery		60,000
(ii) Intangible Assets — Goodwill		22,600
(b) Non-cuirrent investments		
Shares in associate company		30,000
Other Investments at Cost (Quoted Shares)		16,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		23,000
(c) Trade Receivables — Sundry Debtors		19,600
(d) Cash and Cash Equivalents		—
TOTAL		2,12,700

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
1,00,000 Equity Shares of ₹ 1 each fully paid	1,00,000
Issued, Subscribed and Paid-up Capital :	
85,000 Equity Shares of ₹ 1 each fully paid	85,000

The scheme of reconstruction, as approved by the competent authorities, was as under :

(i) The issued equity shares were reduced to 5 paise each paid up, the unpaid value of the share was subsequently called by the company and paid by all the shareholders.

(ii) The balance of unissued capital was allotted to the Bank in part discharge of the loan; the balance due was paid in cash.

(iii) The authorised capital of the company is to be increased by another 50,000 shares and these are to be issued to the existing shareholders as rights issue. The amount due from the shareholders was realised.

(iv) Trade creditors to give up 25% of their claims and the balance due to them to be converted into 12% Secured Debentures of ₹ 100 each.

(v) Interest of ₹ 6,500 on Bank Loan to be waived by the Bank and the balance Bank Loan to be paid-off.

(vi) All amounts available, including securities premium, to be utilised to write-off losses, goodwill and the value of shares in associated companies.

Show the Journal Entries to record the above and also draw the Balance Sheet of the company after the scheme is fully implemented. All workings should form part of your answer.

19. Dee Ltd. decided with the approval of the Tribunal and the sanction of the parties concerned, upon a scheme of reconstruction as at 31st March, 2016.

The summarised Balance Sheet of Dee Ltd. as at that date is as under :

Balance Sheet of Dee Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,40,000
(b) Reserves and Surplus — Capital Reserve		68,000
Profit and Loss		(2,53,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% First Mortgage Debentures		3,15,000
10% Convertible Debentures		6,38,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Loan from Bank (Secured)		1,00,000
(b) Trade Payables — Creditors		94,000
(c) Other current kliabilities — Accrued Interest on Debentures		5,950
Accrued Interest on Convertible Debentures		15,050
TOTAL		22,23,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Land, Building and Machinery		9,45,000
(ii) Intangible Assets — Goodwill		3,80,000
(2) Current Assets :		
(a) Current Investments		3,98,000
(b) Inventories — Work-in-Progress		3,20,000
(c) Trade Receivables — Debtors		1,80,000
TOTAL		22,23,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
82,000 Equity Shares of ₹ 10 each fully paid	8,20,000
42,000, 10% Preference Shares of ₹ 10 each fully paid	4,20,000
	12,40,000

The material points in the scheme are :

(i) Each Convertible Debenture is to be exchanged for ₹ 35 of non-convertible 10 per cent Debentures, ₹ 50 of 13 per cent Preference shares and ₹ 15 of equity shares.

(ii) Each existing 12 per cent Preference Shares is to be written-down from ₹ 10 to ₹ 8 of which ₹ 5 will be represented by 13 per cent Preference Shares and ₹ 3 by Equity Shares.

(iii) Each existing Equity Shares will be written-down from ₹ 10 to ₹ 3.

(iv) Both classes of shares will then be sub-divided into shares of Re 1 each.

(v) The State Finance Corporation has agreed to apply for ₹ 3,75,000 of equity shares paying cash in full on application.

(vi) The reduction of capital and reserves are to be applied in eliminating fictitious assets and the balance to be used in writing-down the Land and Buildings, Plant and Machinery and Investments in the ratio of 3 : 1.

You are required to give the Journal Entries recording the reduction and reorganisation and the resulting summarised Balance Sheet as on 1st April, 2016.

20. Depression Ltd. decided to reorganise its structure following a period of adverse trading conditions. The Balance Sheet of the company as on 31st March, 2016 showed the following :

Balance Sheet of Depression Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,50,000
(b) Reserves and Surplus — Securities Premium		5,000
Profit and Loss Account		(71,700)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 9% Debentures (Secured on freehold property)		60,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		96,000
(b) Trade Payables — Creditors		85,000
(c) Other Current Liabilities — Accrued Interest on Debentures		2,700
TOTAL		5,27,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Freehold Property at Cost		60,000
Leasehold Property		1,22,000
Plant and Machinery		1,60,000
(ii) Intangible Assets — Goodwill at Cost		55,000
(b) Non-current investments		40,000
(2) Current Assets :		
(a) Inventories		30,000
(b) Trade Receivables — Debtors		60,000
TOTAL		5,27,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
3,00,000 Equity Shares of ₹ 1 each	3,00,000
2,00,000, 8% Preference Shares of ₹ 1 each	2,00,000
	5,00,000
Issued, Subscribed and Paid-up Capital :	
3,00,000 Equity Shares of ₹ 1 each, 0.50 paid-up	1,50,000
2,00,000, 8% Preference Shares of ₹ 1 each fully paid	2,00,000
	3,50,000

Note : Preference dividends are in arrears for four years.

Subsequent to approval by the Tribunal of a scheme for the reduction of capital, the following steps were taken :

(i) The Preference Shares were reduced to ₹ 0.75 per share, and the Ordinary Shares to Re 0.10 per share. After reduction the shares were consolidated into Re 1 shares. The authorised capital was restored to 2,00,000, 8% Cumulative Preference Shares and 1,50,000 Ordinary Shares, both of ₹ 1 each.

(ii) 1 new Ordinary Share of ₹ 1 was issued for every ₹ 4 of gross preference dividend in arrears.

(iii) The balance on Securities Premium Account was utilised.

(iv) The debentureholders took over the freehold property at an agreed figure of ₹ 75,000 and paid the balance to the company after deducting the amount due to them.

(v) Plant and Machinery was written-down to ₹ 1,40,000.

(vi) Trade Investment was sold for ₹ 32,000.

(vii) Goodwill, Preliminary Expenses, debt of ₹ 8,600, and Obsolete Stock of ₹ 10,000 were written-off.

(viii) A contingent liability for which no provision had been made was settled at ₹ 7,000 and of the amount ₹ 6,300 was recovered from the insurers.

You are required :

(a) to show the Journal Entries necessary to record the above transactions in the company's books, and

(b) to prepare the Balance Sheet, after completion of the scheme.

21. The following was the Balance Sheet of R Ltd. as on March 31, 2016 :

Balance Sheet of R Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus — Profit and Loss Account		(73,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		50,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		27,350
(b) Trade Payables — Sundry Creditors		9,100
TOTAL		2,13,450
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		60,000
Land and Buildings		55,000
Plant and Machinery		6,500
Motor Vehicles		
(ii) Intangible Assets — Goodwill		30,000
(2) Current Assets :		
(a) Inventories		52,600
(b) Trade Receivables — Sundry Debtors		9,200
(c) Cash and Cash Equivalents — Cash in Hand		150
TOTAL		2,13,450

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
2,000 Equity Shares of ₹ 100 each	2,00,000
1,000, 6% Preference Shares of ₹ 100 each	1,00,000
	3,00,000

Issued, Subscribed and Paid-up Capital :	
1,200 Equity Shares of ₹ 100 each fully paid	1,20,000
800, 6% Preference Shares of ₹ 100 each fully paid	80,000
	2,00,000

No preference dividend has been paid for eight years and the company is handicapped by the antiquated nature of its plant. In the opinion of the directors, if new capital were available and modern plant acquired substantial profits could be earned. Accordingly they proposed a capital reduction scheme as follows :

(i) Each existing Equity Share to be reduced to ₹ 5 each.

(ii) All arrears of Preference Dividend to be cancelled.

(iii) Each existing Preference Share to be reduced to ₹ 75 and then exchanged for one new 6% Cumulative Preference Share of ₹ 50 each and five Equity Shares of ₹ 5 each.

(iv) The credit balance resulting from the above to be applied in eliminating the debit balance on Profit and Loss Account and writing-down Plant and Machinery to ₹ 19,000 and reducing the amount of goodwill.

(v) The unissued Preference and Equity Shares to be divided into shares of ₹ 50 and ₹ 5 each respectively and the authorised capital to be restored to ₹ 3,00,000 by the creation of sufficient new Equity Shares.

(vi) All the Debentures to be redeemed at 105 per cent, holders being given the option to subscribe at par for new 4% Debentures.

Sanction of the Tribunal to the scheme having been obtained, ₹ 40,000 new Equity Shares were issued at par, payable in full on application. The whole issue was underwritten for a commission of 2.5% and was fully taken up. Holders of old Debentures to the extent of ₹ 20,000 exercised their option and subscribed for the New Debentures.

The total expenses incurred by the company in connection with the scheme, excluding underwriting commission, amounted to ₹ 1,350.

You are required to show the Journal Entries necessary to record only the reduction scheme and to set out the company's Balance Sheet after the above arrangements had been carried out.

22. The Balance Sheet of A Co. Ltd. as on 31.3.2016 is as follows :

Balance Sheet of A Co. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	9,50,000
(b) Reserves and Surplus — Profit and Loss Account		(5,00,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6% Debentures (Secured on Freehold Property)		3,75,000
Director's Loan		2,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		12.500
(c) Other Current Liabilities — Accrued Interest on Debentures		22,500
TOTAL		10,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		
Freehold Property		3,50,000
Plant		50,000
(ii) Intangible Assets — Trade Investment		60,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		2,00,000
(c) Trade Receivables — Debtors		4,00,000
TOTAL		10,60,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
75,000 Equity Shares of ₹ 10 each fully paid	7,50,000
2,000, 6% Cumulative Preference Shares of ₹ 100 each fully paid	2,00,000
	9,50,000

The Tribunal approved a Scheme of re-organisation to take effect on 1.4.2016 whereby :

(i) Preference Shares to be written-down to ₹ 75 each and Equity Shares to ₹ 2 each.

(ii) Preference Dividends are in arrears for 4 years, 75% to be waived and Equity Shares of ₹ 2 each to be allotted for the remaining quarter.

(iii) Accrued Debenture Interest to be paid in cash.

(iv) Debentureholders agreed to take over Freehold Property (Book Value — ₹ 1,00,000) at a valuation of ₹ 1,50,000 in part repayment of their holdings and to provide additional Cash of ₹ 1,30,000 secured by a floating charge on the Company's assets at an interest rate of 10% p.a.

(v) Inventories to be written-off fully.

(vi) ₹ 2,33,000 to be provided as bad debts.

(vii) Remaining freehold property to be revalued at ₹ 4,00,000.

(viii) Investments sold out for ₹ 1,50,000.

(ix) In settlement of their loans, Directors are to accept Equity Shares of ₹ 2 each for 90% of their loans, waiving 10% of the balance of their loan amount.

(x) Capital commitments contracts totalling ₹ 3,00,000 are to be cancelled by payment of penalty @ 5% of contract value.

(xi) Taxation and Cost of scheme are to be ignored.

Show Journal Entries reflecting the effect of the above transactions (including cash transactions) and draw-up the Balance Sheet after effecting the scheme.

23. The Balance Sheet of Alpha Ltd. as on 31.3.2016 is as follows:

Balance Sheet of Alpha Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus — Profit and Loss Account		(2,60,000)
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 9% Debentures		2,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		1,50,000
(c) Other Current Liabilities — Outstanding Expenses		50,000
TOTAL		11,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		7,40,000
(ii) Intangible Assets — Goodwill		1,60,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,00,000
(c) Trade Receivables — Debtors		1,35,000
(d) Cash and Cash Equivalents — Cash in Hand		5,000
TOTAL		11,40,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
40,000, 7% Preference Shares of ₹ 10 each fully paid	4,00,000
	10,00,000

The Preference Shares carry the right to a prior return of capital, together with all arrears of dividends. Debentures carry a floating charge on all the assets of the company.

The business has passed through a depression but the worse seems to have been over. Preference dividends for past four years have not been paid. No depreciation has been provided on the Fixed Assets for the past three years. The arrear depreciation is estimated to be ₹ 2,20,000.

The company is assured of a good future. Do you think any reorganisation of capital is desirable, and if so, what form would you suggest ? Give a draft Balance Sheet assuming that your recommendations are acceptable.

24. The following is the Balance Sheet as at 31st March 2016 of Bad Luck Ltd. The company is engaged in the manufacture and sale of electronic items. It has been felt that the depression in the industry is a thing of the past and suitable reconstruction of the company will enable it to recapture its position in the market.

Balance Sheet of Bad Luck Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,00,000
(b) Reserves and Surplus — Profit and Loss Account		(6,00,000)
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		3,00,000
TOTAL		9,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Plant and Machinery		3,00,000
(ii) Intangible Assets — Goodwill		2,50,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		2,00,000
(c) Trade Receivables — Debtors		1,00,000
(d) Cash and Cash Equivalents — Cash in Hand		50,000
TOTAL		9,00,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 100 each fully paid	10,00,000
2,000, 10% Cumulative Preference Shares of ₹ 100 each fully paid	2,00,000
	12,00,000

It is expected that a realisation of the business will yield a new assets position will ₹ 3 lakhs. As an adviser to the company, what plan of reconstruction will you propose ? Draw up the Balance Sheet of the company after your scheme is put into effect. ***[I.C.W.A. (Final) — Adapted]***

25. The Balance Sheet of the Premier Co. Ltd. is as follows :

Balance Sheet of Premier Co. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,50,000
(b) Reserves and Surplus — General Reserve		15,000
Profit and Loss Account		(45,000)
Staff Welfare Fund		10,000
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 6% Debentures		30,000
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Sundry Creditors		45,000
TOTAL		3,05,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets —		
Buildings		1,20,000
Plant I		40,000
Plant II		48,000
(ii) Intangible Assets — Goodwill		25,000
(2) Current Assets :		
(a) Current Investments		20,000
(b) Inventories		15,000
(c) Trade Receivables — Sundry Debtors		30,000
(d) Cash and Cash Equivalents — Cash at Bank		7,000
TOTAL		3,05,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Issued, Subscribed and Paid-up Capital :	
30,000 Equity Shares of ₹ 10 each, ₹ 5 per share paid-up	1,50,000
20,000, 7% Preference Shares of ₹ 5 each fully paid	1,00,000
	2,50,000

As the company has been making losses for some time and the financial prospects seem to be unfavourable under its present financial setup, you are required to draw up a scheme of financial reorganisation, involving capital reduction. Show the new Balance Sheet of the company on the assumption that your scheme is given effect to.

The following are certain relevant facts that may be considered in drawing up the scheme :

(a) Investments are valued at ₹ 25,000 in the market.

(b) Preference Shares are cumulative and preferential as regards dividend as well as capital.

(c) The company needs to have liquid resources of ₹ 15,000 for working capital purposes.

(d) Bad Debts are estimated at ₹ 1,500.

(e) Plant II, which was acquired after the issue of Debentures, is not put to proper use due to the retirement of a skilled engineer, who could not be replaced. The market value of Plant II is 5% below book value.

Guide to the Answers

Multiple Choice

1. C; 2. A; 3. B; 4. B. 5. C

Practical Questions

1. Total amount of capital reduction — ₹ 3,50,000. Balance Sheet total — ₹ 4,59,000. Debit : Securities Premium and Credit: Capital reduction.
2. Total amount of capital reduction — ₹ 1,00,000. ₹ 10,000 is to be transferred to Capital Reserve Account.
3. Total amount of capital reduction — ₹ 1,25,000; Balance Sheet total — ₹ 2,15,000.
4. Total amount of capital reduction — ₹ 5,00,000; Balance of Capital Reduction Account — ₹ 80,000 is to be transferred to Capital Reserve Account.
5. Total amount of capital reduction — ₹ 7,50,000; Balance Sheet total — ₹ 5,50,000.
6. Total amount of capital reduction — ₹ 3,20,000; Balance Sheet total — ₹ 5,50,000.
7. Total amount of capital reduction — ₹ 5,15,000; Balance Sheet total — ₹ 10,28,000.
8. Total amount of capital reduction — ₹ 42,300; Balance Sheet total — ₹ 1,03,125.
9. Profit and Loss Account (Dr.) — ₹ 10,00,000; Total amount of capital reduction — ₹ 15,40,000; Balance Sheet total — ₹ 11,00,000; Total fixed assets to be written off — ₹ 5,20,000.
10. Total amount of capital reduction — ₹ 5,27,000; Balance Sheet total — ₹ 3,10,000.
11. Total amount of capital reduction — ₹ 7,12,500; Balance Sheet total — ₹ 15,25,000.
12. Balance Sheet total — ₹ 9,35,000.
13. Balance Sheet total — ₹ 33,00,000 (after payment of tax of ₹ 4,00,000). Total amount of capital reduction — ₹ 17,00,000.
14. Balance Sheet total — ₹ 11,65,000; Amount transferred to Capital Reserve — ₹ 1,40,000. Total amount of capital reduction — ₹ 6,00,000. Remission accepted by the creditors — ₹ 50,000.
15. Balance Sheet total — ₹ 10,71,000; Amount transferred to Capital Reserve — ₹ 72,000. Total amount of capital reduction — ₹ 5,58,000.
16. Balance Sheet total — ₹ 1,80,000; Total amount of capital reduction — ₹ 11,35,000.
17. Total amount of capital reduction — ₹ 34,20,000; Capital Reserve — ₹ 3,70,000; Balance Sheet total — ₹ 30,90,000.
18. Balance Sheet total — ₹ 1,98,3000; Total amount of capital reduction ₹ 1,18,375.
19. Balance Sheet total — ₹ 20,25,000; Total amount of capital reduction — ₹ 7,26,000.
20. Balance Sheet total — ₹ 3,33,400; Total amount capital reduction — ₹ 1,45,300.
21. Balance Sheet total — ₹ 1,63,450; Total amount of capital reduction — ₹ 1,34,000. Premium on redemption of debentures — ₹ 2,500; Commission on issue of shares — ₹ 1,000; and reconstruction expenses are adjusted against Capital Reduction Account. The balance of Capital Reduction Account has been used for writing-off goodwill.
22. Balance Sheet total — ₹ 8,59,000; Total amount of capital reduction — ₹ 8,43,000.

[No answer has been given for practical problem nos. 23, 24 and 25 because the answers will vary on the basis of assumptions.]

12

Holding Company

Introduction

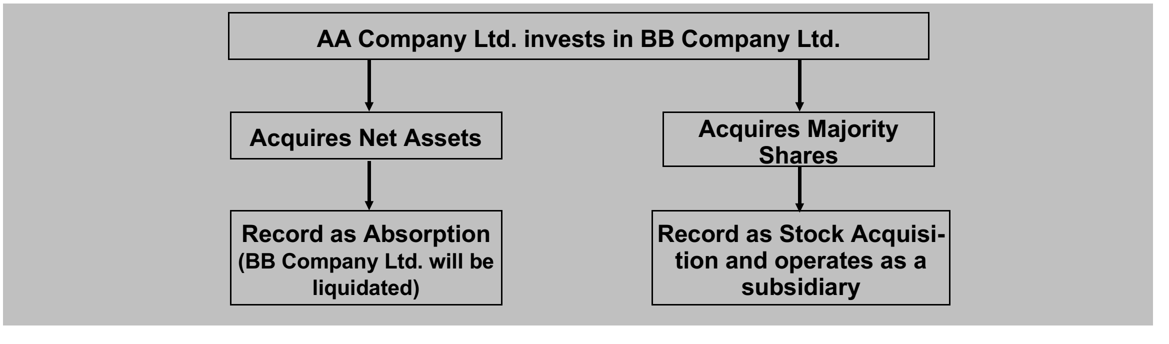
There are different ways by which one company can gain control over other companies.

One way is to acquire all the assets and liabilities of the companies concerned thereby securing control by ownership of such assets and liabilities. This arrangement is termed as ***absorption***. In this case, the acquired company will go into liquidation. (For details please see chapter 'Amalgamation').

Another way is to acquire all or the majority (50% and above) of the voting shares of these companies. The company acquiring the shares is known as the ***holding company***; the company whose shares have been acquired is known as ***subsidiary company*** of the holding company. The subsidiary company continues to operate as before, the only difference being that it now has a majority shareholder (the holding company). The relationship between a holding company and a subsidiary company is basically one of control.

The advantages of acquiring control through this method are two-folds — financial and managerial. Financially, it is a favourite device. A holding company can control large properties of a subsidiary with a minimum of investment. Managerially, it is possible to decentralise operations with full responsibility and accountability to the subsidiary.

Determining the Types of Control



Legal Definition and Requirements

Meaning of Holding Company and Subsidiary

As per the provisions of Section 2(87) of the Companies Act, 2013, ''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 purpose 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;

(d) ''layer'' in relation to a holding company means its subsidiary or subsidiaries;

It is to be noted that for the purpose of definition of subsidiary and associate company, 'total share capital' comprises paid-up equity share capital and convertible preference share capital. In our opinion, convertible preference shares includes both compulsorily and optionally convertible preference shares.

Students should note that :

(1) Non-convertible preference shares should not be taken into consideration for determining subsidiary / associate company.

(2) Convertible warrants or options and convertible debentures are also not to be taken into consideration for determining subsidiary / associate company.

Accounting Standard (AS) — 21 'Consolidated Financial Statements' defined 'subsidiary' and 'parent' as:

A ***subsidiary*** is an enterprise that is controlled by another enterprise (known as the 'parent').

Parent enterprise is an enterprise that has one or more subsidiaries.

In this respect, the meaning of the word '***control***' is very important. AS — 21 has defined 'control' as follows:

"(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the ***voting power*** of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economical benefits from its activities."

If you read between the lines, the definition of 'subsidiary company' as per the Companies Act, 2013 and AS—21 are not same. The word 'control' under AS—21 is based on ***voting power*** whereas under the Companies Act, 2013, it is based on ***total share capital*** ownership. It is important to mention here that 'total share capital' consists of two parts — equity share capital and convertible preference share capital. AS—21 read with AS—23 is very clear that potential equity share (convertible preference shares) are not considered for determining the voting power. Now the question may arise that which definition of the 'subsidiary company' should be used for preparing Consolidation of Financial Statements ?

In our opinion, the definition of 'subsidiary' (based on voting power) as per AS—21 is to be taken into consideration. The Accounts Rules, among other things, state that consolidation of financial statements will be made in accordance with applicable accounting standards.

Requirements of Companies Act, 2013 in Respect of Consolidation of Financial Statements

Section 129(3) of the Companies Act, 2013 requires that a company having one or more subsidiary, shall prepare a ***Consolidated Financial Statement*** (CFS) of the company and of all the subsidiaries in the same forms and manner as ***Standalone Financial Statement*** (SFS) of the parent company.

At every annual general meeting of the company, the Board of Directors of the company shall lay before the meeting both SFS and CFS of the company.

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in AOC–1:

Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.

***Explanation*.—**For the purposes of this sub-section, the word ‘‘subsidiary’’ shall include associate company and joint venture.

Where the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

***Explanation*.—**For the purposes of this section, except where the context otherwise requires, any reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.

Students should note the following points :

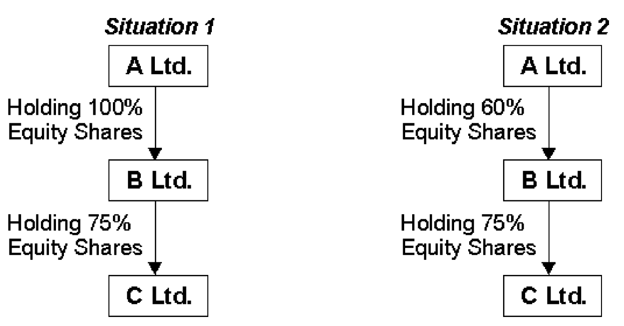
(1) The Companies Act, 2013 requires that all companies having one or more subsidiary joint ventures or associates must prepare consolidated financial statements..

(2) The Companies Act, 2013 requires consolidated financial statements to be prepared even for companies who do not have subsidiaries but only have associates or joint ventures. It is effective from the year ending on 31st March, 2016.

(3) It may happen that a subsidiary company is having its own subsidiary. The Companies Act, 2013 requires that the intermediate holding company will have to prepare consolidated financial statements along with ultimate parent company.

Let us assume that C Ltd. is the subsidiary of B ltd. and B Ltd. is the subsidiary of A Ltd. In this case, both A Ltd. and B Ltd. will have to prepare consolidated financial statements. However, no consolidated financial statement is to be prepared by B Ltd. if it is a wholly-owned subsidiary.

The following diagram will clear the matter :



In ***situation 1***, only A Ltd. will have to prepare consolidated financial statement.

In ***situation 2***, both A Ltd. and B Ltd. will have to prepare consolidated financial statement.

Advantages of Consolidation of Financial Statements

The following are the advantages of consolidation of financial statements:

(a) Reported financial position and annual results of the subsidiary are taken into account and not merely their dividends. A consolidated Balance Sheet includes a subsidiary irrespective of the fact that it is a loss-making or a profit making subsidiary.

(b) A consolidated Balance Sheet shows all the assets and liabilities of the holding company and its subsidiaries, not merely the operating assets of the holding company in its own business and the investment made in the subsidiary.

(c) Total liquidity of the holding company and its subsidiary can be measured, not just those of the parent company.

Disadvantages of Consolidation of Financial Statements

The following are the main disadvantages of consolidation of financial statements :

(a) Aggregating the results of holding company and its subsidiary may conceal important information from shareholders when the companies differ in respect to profitability, business risk and growth potential.

(b) Consolidation may mislead the shareholders if the activities of the subsidiary are very dissimilar from those of other companies within the group.

Consolidation of Financial Statements and Accounting Standards

Introduction

Accounting Standards (AS) — 21 'Consolidated Financial Statements', issued by the Council of the Institute of Chartered Accountants of India as amended as per The Companies (Accounting Standards) Amendment Rules, 2016, is mandatory if an enterprises presents consolidated financial statements. In other words, the accounting standards does not mandate an enterprise to present consolidated financial statement but, if the enterprise presents consolidated financial statement for complying with the requirements of any statute or otherwise, it should be prepared and present consolidated financial statements in accordance with AS–21.

Objective

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

Scope

1. This Standard should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.
2. This Standard should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.
3. In the preparation of consolidated financial statements, other Accounting Standards also apply in the same manner as they apply to the separate financial statements.
4. This Standard does not deal with:
    a. methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (see AS 14, Accounting for Amalgamations);

b. accounting for investments in associates (at present governed by AS 23, Accounting for Investments in Associates in Consolidated Financial Statement); and
c. accounting for investments in joint ventures (at present governed by AS 27, Financial Reporting of Interest in Joint Venture).

Definitions

5. For the purpose of this Standard, the following terms are used with the meanings specified:

Control:

a. the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or
b. control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

A ***subsidiary*** is an enterprise that is controlled by another enterprise (known as the parent).

A ***parent*** is an enterprise that has one or more subsidiaries.

A ***group*** is a parent and all its subsidiaries.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Minority interest is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

6. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements.

Explanation: All the notes appearing in the separate financial statements of the parent enterprise and its subsidiaries need not be included in the notes to the consolidated financial statements. For preparing consolidated financial statements, the following principles may be observed in respect of notes and other explanatory material that form an integral part thereof:

(a) Notes which are necessary for presenting a true and fair view of the consolidated financial statements are included in the consolidated financial statements as an integral part thereof.
(b) Only the notes involving items which are material need to be disclosed. Materiality for this purpose is assessed in relation to the information contained in consolidated financial statements. In view of this, it is possible that certain notes which are disclosed in separate financial statements of a parent or a subsidiary would not be required to be disclosed in the consolidated financial statements when the test of materiality is applied in the context of consolidated financial statements.
(c) Additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having no bearing on the true and fair view of the consolidated financial statements need not be disclosed in the consolidated financial statements. An illustration of such information in the case of companies is attached to the Standard.

Presentation of Consolidated Financial Statements

7. A parent which presents consolidated financial statements should present these statements in addition to its separate financial statements.
8. Users of the financial statements of a parent are usually concerned with, and need to be informed about, the financial position and results of operations of not only the enterprise itself but also of the group as a whole. This need is served by providing the users -

a. separate financial statements of the parent; and
b. consolidated financial statements, which present financial information about the group as that of a single enterprise without regard to the legal boundaries of the separate legal entities.

Scope of Consolidated Financial Statements

9. A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign, other than those referred to in paragraph 11. Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements, and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively.

10. The consolidated financial statements are prepared on the basis of financial statements of parent and all enterprises that are controlled by the parent, other than those subsidiaries excluded for the reasons set out in paragraph 11. Control exists when the parent owns, directly or indirectly through subsidiary(ies), more than one-half of the voting power of an enterprise. Control also exists when an enterprise controls the composition of the board of directors (in the case of a company) or of the corresponding governing body (in case of an enterprise not being a company) so as to obtain economic benefits from its activities. An enterprise may control the composition of the governing bodies of entities such as gratuity trust, provident fund trust etc.

    Since the objective of control over such entities is not to obtain economic benefits from their activities, these are not considered for the purpose of preparation of consolidated financial statements. For the purpose of this Standard, an enterprise is considered to control the composition of:

    (i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director, if any of the following conditions is satisfied:
        (a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or
        (b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or
        (c) the director is nominated by that enterprise or a subsidiary thereof.

    (ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member, if any of the following conditions is satisfied:
        (a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or
        (b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or
        (c) the member of the governing body is nominated by that other enterprise.

    Explanation: It is possible that an enterprise is controlled by two enterprises – one controls by virtue of ownership of majority of the voting power of that enterprise and the other controls, by virtue of an agreement or otherwise, the composition of the board of directors so as to obtain economic benefits from its activities. In such a rare situation, when an enterprise is controlled by two enterprises as per the definition of 'control', the first mentioned enterprise will be considered as subsidiary of both the controlling enterprises within the meaning of this Standard and, therefore, both the enterprises need to consolidate the financial statements of that enterprise as per the requirements of this Standard.

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

    In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

Explanation:

(a) Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise is considered to be temporary within the meaning of paragraph 11(a).

(b) The period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investment, such an investment is not excluded from consolidation, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention.

12. Exclusion of a subsidiary from consolidation on the ground that its business activities are dissimilar from those of the other enterprises within the group is not justified because better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by Accounting Standard (AS) 17, Segment Reporting, help to explain the significance of different business activities within the group.

Consolidation Procedures

13. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:

a. the cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;

b. any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as ***goodwill*** to be recognised as an asset in the consolidated financial statements;

c. when the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a ***capital reserve*** in the consolidated financial statements;

d. minority interests in the net income of consolidated subsidiaries for the reporting period should be 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

e. minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:

   i. the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

   ii. the minorities' share of movements in equity since the date the parent-subsidiary relationship came into existence.

   Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

14. The parent's portion of equity in a subsidiary, at the date on which investment is made, is determined on the basis of information contained in the financial statements of the subsidiary as on the date of investment. However, if the financial statements of a subsidiary, as on the date of investment, are not available and if it is impracticable to draw the financial statements of the subsidiary as on that date, financial statements of the subsidiary for the immediately preceding period are used as a basis for consolidation. Adjustments are made to these financial statements for the effects of significant transactions or other events that occur between the date of such financial statements and the date of investment in the subsidiary.
15. If an enterprise makes two or more investments in another enterprise at different dates and eventually obtains control of the other enterprise, the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence. If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment, for the purposes of paragraph 13 above, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.
16. Intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.
17. Intragroup balances and 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.
18. The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.
19. The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements are usually drawn up to the same date. When the reporting dates are different, the subsidiary often prepares, for consolidation purposes, statements as at the same date as that of the parent. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months. The consistency principle requires that the length of the reporting periods and any difference in the reporting dates should be the same from period to period.
20. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.
21. If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements when they are used in preparing the consolidated financial statements.
22. The results of operations of a subsidiary are included in the consolidated financial statements as from the date on which parent-subsidiary relationship came in existence. The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship. The difference between the proceeds from the disposal of investment in a subsidiary and the carrying amount of its assets less

liabilities as of the date of disposal is recognised in the consolidated statement of profit and loss as the profit or loss on the disposal of the investment in the subsidiary. In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period.

23. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments, from the date that the enterprise ceases to be a subsidiary and does not become an associate10.
24. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.
25. Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.
26. 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.
27. If a subsidiary has outstanding cumulative preference shares which are held outside the group, the parent computes its share of profits or losses after adjusting for the subsidiary's preference dividends, whether or not dividends have been declared.

Disclosure

29. In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:
    a. in consolidated financial statements a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;
    b. in consolidated financial statements, where applicable:
        i. the nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;
        ii. the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and
        iii. the names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

Real Life Focus
Kirloskar Brothers Limited

Accounting Policies

Principles of Consolidation

(i) The consolidated financial statements relate to Kirloskar Brothers Limited (KBL) and

(a) its majority owned subsidiary companies, consolidated on a line by line basis by adding together the book values of like items of assets, liabilities, income and expenses, after fully eliminating intra-group transactions and the unrealised profits / losses on intra-group transactions, and are presented to the extent possible, in the manner as the Company's independent financial statements.

The names of the subsidiary companies, country of incorporation, proportion of ownership interest and reporting dates considered in the consolidated financial statements are :

Name of the Company	Country of Incorporation	Proportion of Ownership Interest of KBL	Reporting Date
Kirloskar Constructions and Engineers Ltd	India	100%	31st March, 2013
Kirloskar Brothers International B V (Consolidated Financial Statements)	The Netherlands	100%	31st December, 2016
The Kolhapur Steel Limited	India	95.95%	31st March, 2013
Hematic Motors Private Ltd	India	100%	31st March, 2013
Kirloskar Corrocoat Private Ltd	India	65%	31st March, 2013
Kirloskar Systech Ltd	India	100%	31st March, 2013

The excess of cost to the company of its investment in the subsidiary company over the partners' portion of equity is recognised in the consolidated financial statements as goodwill. The excess of company's share of equity of the subsidiary company over the cost of acquisition is treated as capital reserve.

[Source : Annual Report 2016-13 (page 104)]

Basic Rules for Preparing a Consolidated Balance Sheet

Rule 1 : Cancellation of Investment and Share Capital

A Consolidated Balance Sheet can be prepared by simply combining all the assets and liabilities of the holding company and its subsidiary. It will certainly balance, but it is not a Consolidated Balance Sheet. This is because the inter-company balances have first to be eliminated. The "Investment in Subsidiary Company" by the holding company should cancel out the Share Capital of the subsidiary company. Consider the following example.

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Share Capital (Equity Share of ₹ 10 each)	1,00,000	40,000	Fixed Assets Investment — 4,000 shares in S Ltd. at par	60,000 40,000	40,000 —
	1,00,000	40,000		1,00,000	40,000

If the assets and liabilities of both the companies are combined, the resultant Balance Sheet be as under :

Liabilities	₹	Assets	₹
Share Capital of H Ltd. Share Capital of S Ltd.	1,00,000 40,000	Fixed Assets (₹ 60,000 + ₹ 40,000) Investment — Shares in S Ltd.	1,00,000 40,000
	1,40,000		1,40,000

The above Balance Sheet does not reveal the reality of the situation, because it counts the same item twice — once as an asset and once as a liability. The inter-company balances of "Investment" and "Share Capital of S" are to be cancelled out to show the position of the group as a whole to the users of accounting information (particularly the shareholders of the holding company).

Therefore, the main work in the preparation of Consolidated Balance Sheet is to cancel out the above two items so that the group accounts reflect the reality of the economic situation. If a correct Consolidated Balance Sheet is prepared, the share capital of the subsidiary company and the investment in shares of S Ltd. of holding company will not find a place in the Consolidated Balance Sheet and the Balance Sheet would appear as under:

Liabilities	₹	Assets	₹
Share Capital	1,00,000	Fixed Assets (₹ 60,000 + ₹ 40,000)	1,00,000

Rule 2 : Minority Interest Calculation

When the holding company acquires all the shares of the subsidiary company, the latter company becomes a ***wholly owned subsidiary***. In our previous example, S Ltd. is a wholly owned subsidiary of H Ltd. But when the holding company acquires more than half but less than all the shares of the subsidiary company, those shareholders who have a minority share are referred to as ***Minority Shareholders***. The interest of the minority shareholders, known as ***Minority Interest*** must be accounted for separately in the Consolidated Balance Sheet.

A minority interest is the proportion of the subsidiary company's net assets / shareholders' fund which belongs to the minority shareholders. Therefore, the value of the minority interest is the portion of the share capital and reserves at the date when the holding company acquires its controlling interest and the share of income after acquisition.

Example

H Ltd. acquired 80% of the shares of S Ltd. for ₹ 40,000. The Balance Sheet of the two companies are as under :

Balance Sheets of H Ltd. and S Ltd. as at . . .

Particulars	Note No.	H Ltd. (₹)	S Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,00,000	50,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures (Secured)		40,000	—
(4) Current Liabilities :			
(a) Other Current Liabilities		60,000	20,000
TOTAL		3,00,000	70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and machinery		1,90,000	40,000
(b) Non-current Investments — 4,000 Equity Shares in S Ltd. at par		40,000	—
(2) Current Assets :			
(a) Other Current Assets		70,000	30,000
TOTAL		3,00,000	70,000

Prepare a Consolidated Balance Sheet.

Solution

Since H Ltd. holds 80% of the shares of S Ltd., 20% of the shares of S Ltd. belongs to minority shareholders, i.e., minority interest is 20%. The net assets of S Ltd. is ₹ 50,000 (₹ 70,000 – ₹ 20,000). 80% (80% of ₹ 50,000 = ₹ 40,000) belongs to the shareholders of H Ltd., while 20% (20% of ₹ 50,000 = ₹ 10,000) belongs to the minority shareholders. This is the minority interest. The Consolidated Balance sheet can be prepared as under :

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus		—
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—

(3) Minority Interest		10,000
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	40,000
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities	(3)	80,000
(d) Short-term Provisions		—
TOTAL		3,30,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,30,000
(2) Current Assets :		
(a) Other Current Assets	(5)	1,00,000
TOTAL		3,30,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000

(2) Long-term Borrowings

Secured	
10% Debentures	40,000

(3) Other Current Liabilities

H Ltd	60,000
S Ltd	20,000
	80,000

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	
H Ltd	1,90,000
S Ltd	40,000
	2,30,000

(5) Other Current Assets

H Ltd	70,000
S Ltd	30,000
	1,00,000

Regarding minority interest, following are the points to be remembered :

1. ***Minority interest is not a liability but capital of the group which does not belong to the shareholders of the holding company.***
2. ***Minority interest is always calculated at the date of the Consolidated Balance Sheet — not when the holding company takes the control.***

Rule 3 : Goodwill / Capital Reserve on Consolidation

When the value of "Investment in Subsidiary" in the holding company's Balance Sheet is ***more*** than the book value of the net assets acquired, the difference represents ***"Goodwill on Consolidation"***. In this case, Investment in Subsidiary will not cancel out against the share capital of the subsidiary unless a goodwill equal to the difference of the two items is shown on the assets side of the Consolidated Balance Sheet. Conversely, if the value of Investment in Subsidiary is ***less*** than the book value of the net assets acquired, the difference represents ***Capital Reserve on Consolidation***. In this case also, Investment in Subsidiary will not cancel out against the share capital of the subsidiary unless a capital reserve equal to the difference of the two items is shown on the liabilities side of the Consolidated Balance Sheet.

To calculate goodwill or capital reserve, the value of the net assets acquired by the holding company in the subsidiary company must be compared with the cost of the investment. This value can be ascertained by adding together proportionate share capital and reserve of the subsidiary.

Goodwill on consolidation arises when holding company consider that subsidiary is worth more than the book value of its net assets. This leads one to believe that those assets can earn super profits and the difference between the real value and the book value is termed as goodwill. On the other hand, capital reserve arises when the shares are purchased by the holding company at a price less than the book value of the net assets acquired.

Example

H Ltd. acquired 80% of the shares of S Ltd. for ₹ 48,000. The Balance Sheets of the two companies are as under :

Balance Sheets of H Ltd. and S Ltd. as at . . .

Particulars	Note No.	H Ltd. (₹)	S Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,00,000	50,000
(b) Reserves and Surplus			
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures (Secured)		40,000	—
(4) Current Liabilities :			
(c) Other Current Liabilities		60,000	20,000
TOTAL		3,00,000	70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		1,90,000	40,000
(b) Non-current Investments — 4,000 Equity Shares of S Ltd. @ ₹ 12 per share		48,000	—
(2) Current Assets :			
(a) Other Current Assets		62,000	30,000
TOTAL		3,00,000	70,000

Prepare a Consolidated Balance Sheet.

Solution

Cost of investment in subsidiary is ₹ 48,000. The value of net assets acquired is ₹ 40,000, i.e., 80% of (₹ 70,000 – ₹ 20,000). Therefore, goodwill on consolidation is ₹ 8,000 (₹ 48,000 – ₹ 40,000). The Consolidated Balance Sheet can be prepared as under:

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest		10,000
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(2)	40,000
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities	(3)	80,000
(d) Short-term Provisions		—
TOTAL		3,30,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(4)	2,30,000
(ii) Intangible Assets	(4)	8,000
(2) Current Assets :		
(a) Other Current Assets	(5)	92,000
TOTAL		3,30,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000

(2) Long-term Borrowings

Secured	
10% Debentures	40,000

(3) Other Current Liabilities

H Ltd	60,000
S Ltd	20,000
	80,000

(4) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	
H Ltd	1,90,000
S Ltd	40,000
	2,30,000
Intangible Assets :	
Goodwill (₹ 48,000 – 40,000)	8,000

(5) Other Current Assets

H Ltd	62,000
S Ltd	30,000
	92,000

Example

H Ltd. acquired 80% of the shares of S Ltd. for ₹ 36,000. The Balance Sheets of the two companies are as under :

Balance Sheets of H Ltd. and S Ltd. as at . . .

Particulars	Note No.	H Ltd. (₹)	S Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,00,000	50,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures (Secured)		40,000	—
(4) Current Liabilities :			
(a) Other Current Liabilities		60,000	20,000
TOTAL		3,00,000	70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		1,90,000	40,000
(b) Non-current Investments — 4,000 Equity Shares of S Ltd. @ ₹ 9 per share		36,000	—
(2) Current Assets :			
(a) Other Current Assets		74,000	30,000
TOTAL		3,00,000	70,000

Solution

Cost of investment in subsidiary is ₹ 36,000. The value of net assets acquired is ₹ 40,000, i.e., 80% of (₹ 70,000 – ₹ 20,000). Therefore, capital reserve on consolidation is ₹ 4,000 (₹ 40,000 – ₹ 36,000). The Consolidated Balance Sheet can be prepared as under:

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at ...

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus	(2)	4,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest		10,000
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	40,000
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities	(4)	80,000
TOTAL		3,34,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,30,000
(2) Current Assets :		
(a) Other Current Assets	(6)	1,04,000
TOTAL		3,34,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000

(2) Reserve and Surplus

Capital Reserve	4,000

(3) Long-term Borrowings

Secured	
10% Debentures	40,000

(4) Other Current Liabilities

H Ltd	60,000
S Ltd	20,000
	80,000

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	
H Ltd	1,90,000
S Ltd	40,000
	2,30,000

(6) Other Current Assets

H Ltd	74,000
S Ltd	30,000
	1,04,000

Rule 4 : Reserves of the Holding and Subsidiary Company

While preparing Consolidated Balance Sheet, reserves of the subsidiary company are treated just as though they were part of the share capital of the subsidiary company. Therefore, while calculating goodwill or capital reserve on consolidation and the minority interest, reserves are to be apportioned between the holding company and the minority shareholders. The reserves of the subsidiary company at the date of the acquisition form a part of goodwill / capital reserve and minority interest calculation.

The reserves of the holding company, on the other hand, belong entirely to the shareholders of the holding company and as such they are shown along with the holding company's share capital in the Consolidated Balance Sheet.

Example

H Ltd. acquired 80% of the shares of S Ltd. on 31.3.2016 for ₹ 48,000. The Balance Sheets of the two companies on that date are as under :

Balance Sheets of H Ltd. and S Ltd. as at 31st March, 2016

Particulars	Note No.	H Ltd. (₹)	S Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,00,000	50,000
(b) Reserves and Surplus — General Reserve		50,000	10,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures (Secured)		40,000	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables			
(c) Other Current Liabilities		60,000	20,000
TOTAL		3,50,000	80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and machinery		1,90,000	40,000
(b) Non-current Investments — 4,000 Equity Shares of S Ltd @ ₹ 12 each		48,000	—
(2) Current Assets :			
(a) Other Current Assets		1,12,000	40,000
TOTAL		3,50,000	80,000

Prepare a Consolidated Balance Sheet as on 31.3.2016.

Solution

H Ltd. holds 80% and minority shareholders hold 20% shares of S Ltd. Therefore, 80% of the net assets / shareholders equity (share capital + general reserve) belong to H Ltd. and 20% belong to minority shareholders. S Ltd.'s net assets = 60,000 (₹ 40,000 + ₹ 40,000 – ₹ 20,000).

Alternatively, shareholders' equity is also ₹ 60,000 (₹ 50,000 share capital + ₹ 10,000 general reserve).

H Ltd. share of net assets = 80% of ₹ 60,000 = ₹ 48,000 and that of minority shareholders = 20% of ₹ 60,000 = ₹ 12,000. Cost of investment is ₹ 48,000 and share of net assets is also ₹ 48,000.

Therefore, there will be no goodwill in the Consolidated Balance Sheet. H Ltd.'s general reserve will be shown in the Consolidated Balance Sheet in the usual manner.

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus	(2)	50,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest		12,000
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(3)	40,000
(5) Current Liabilities :		—
(c) Other Current Liabilities	(4)	80,000
(d) Short-term Provisions		—
TOTAL		3,82,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,30,000
(2) Current Assets :		
(a) Other Current Assets	(6)	1,52,000
TOTAL		3,82,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve	50,000

(3) Long-term Borrowings

Particulars	₹
Secured	
10% Debentures	40,000

(4) Other Current Liabilities

Particulars	₹
H Ltd	60,000
S Ltd	20,000
	80,000

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Plant and Machinery	
H Ltd	1,90,000
S Ltd	40,000
	2,30,000

(6) Other Current Assets

Particulars	₹
H Ltd	1,12,000
S Ltd	40,000
	1,52,000

Rule 5 : Pre- and Post-acquisition Profit of Subsidiary

The profits earned by the subsidiary company before the holding company acquires its control, is known as ***pre-acquisition profit*** or ***capital profit***. Undrawn pre-acquisition profit is taken into consolidation for calculation of goodwill or capital reserve. It is split between cost of control (goodwill / capital reserve calculation) and minority interest.

The profits earned by the subsidiary company after the holding company acquires its control, is known as ***post-acquisition profit*** or ***revenue profit***, which can be distributed as dividend. It should be noted that post-acquisition profit of a subsidiary company do not form part of the goodwill or capital reserve calculation.

Minority shareholders are not concerned whether the profits are pre-acquisition or post-acquisition. Post-acquisition profit is apportioned between holding company and minority shareholders. The share of holding company is added with its profit, while the share of the minority shareholders form a part of the calculation of minority interest.

Rule 6 : Cancellation of Inter-company Debts and Acceptances

It is very common that member companies have business dealing not only with outsiders but also with each other. Inter-company transactions may lead to inter-company debts and acceptances. At the time of consolidation, inter-company debts and acceptances which are part of the same group, are to be cancelled out as follows:

Inter-company Debts

Inter-company debts for the sale of goods on credit owing by one company to the other company in the same group should be eliminated from sundry debtors and sundry creditors. For example, if the holding company sells goods to its subsidiary for ₹ 10,000 on credit, it will appear as one of the sundry debtors in the Balance Sheet of holding company and as one of the sundry creditors in the Balance Sheet of the subsidiary company. It is an internal debt and is neither an external asset nor a liability of the group.

While preparing Consolidated Balance Sheet, sundry debtors of both the companies are to be added together. Similarly, sundry creditors of both the companies are to be added together. From this merged balance of sundry debtors and sundry creditors, a sum of ₹ 10,000 is to be deducted from both the balances. If the above adjustment is not done it will lead to an over-statement of the figures for current assets and current liabilities in the Consolidated Balance Sheet.

Inter-company Bills of Exchange

Bills drawn or accepted either by the holding company or its subsidiary is not an outside obligation. The item "Bills Receivable" in one company's Balance Sheet and corresponding item "Bills Payable" in another company's Balance Sheet are to be cancelled out against each other like ordinary debts.

But if some of the bills are discounted, their adjustment is not possible because they are no longer an inter-company obligation. When a bill is discounted, it will have to be paid by the drawee (if not, by the drawer in case of dishonour) to the bank (outside the group).

Bills discounted generally appear at the bottom of the Balance Sheet as a contingent liability. In the Consolidated Balance Sheet it will also appear as a contingent liability. Only the face value of the bills that are drawn on outsiders and subsequently discounted, will appear as a contingent liability in the Consolidated Balance Sheet as a footnote.

Rule 7 : Cancellation of Inter-company Loans and Advances

Usually a Current Account is used to record inter-company loans and advances. When a loan is provided by either of the companies to the other, a current account will exist between the holding company and its subsidiary. For example, if the holding company makes a loan of ₹ 10,000 to its subsidiary, it will appear as an asset in the Balance Sheet of the holding company and as a liability in the Balance Sheet of the subsidiary company. At the time of preparing the Consolidated Balance Sheet, these two amounts are to be cancelled out.

A difficulty arises where the current accounts maintained by the holding company and its subsidiary show different figures as to the balance owed. At the time of preparing the Consolidated Balance Sheet, these two current accounts are to be reconciled if they are not in agreement by comparing the entries in the accounts. Any remaining difference is usually caused by goods-in- transit from the seller to the buyer, or cash-in-transit from the buyer to the seller. In the Consolidated Balance Sheet, the cash or goods-in-transit will appear as one of the assets and the two current accounts will cancel each other out.

The general rule in these circumstances is that adjustment should be made to the holding company's balance, whichever way the goods or cash are going, because it is easier for the holding company's accountant to make the adjustment. [***Please see Illustration 13***]

Rule 8 : Adjustment of Bank Balances

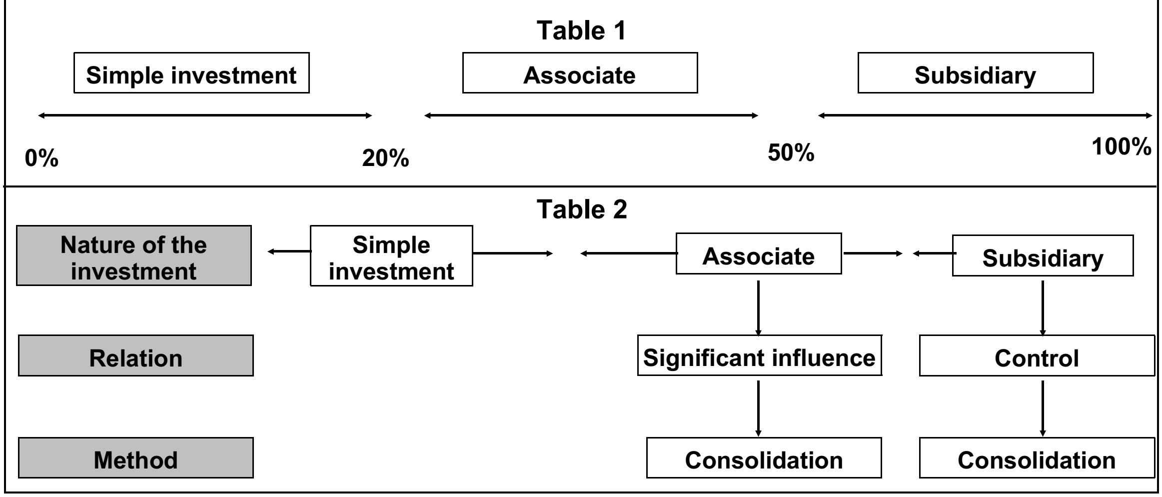
Bank accounts may be held by the holding company and its subsidiary at different banks. While some balances are favourable, others are overdrawn balances, they should appear in the Consolidated Balance Sheet as assets and liabilities respectively. It would be incorrect to adjust the overdraft balances against credit balances for the purpose of the Consolidated Balance Sheet.

But when both the companies maintain their bank accounts at the same branch and the bank has a 'set off' agreement between the holding company and its subsidiary, the usual method is to combine all bank balances and to set off overdraft against credit balances.

Points to Remember

1. ***The investment in a subsidiary is replaced by the underlying net assets of the subsidiary.***
2. ***Assets and liabilities are added on a line-by-line basis to the corresponding asset and liability amounts of the holding company.***
3. ***100% of each asset and liability is aggregated even if the holding company owns a controlling interest of less than 100%.***
4. ***The minority shareholders' interest in the net assets not owned by the holding company is shown as a liability of the Group in the Consolidated Balance Sheet.***
5. ***Assets are stated at their cost to the Group, rather than at their cost to any individual company. Thus, inter-company profit arising out of stock and fixed assets transfers are removed. (They are usually referred to as unrealised profit).***
6. ***Any inter-company debtors/creditors; bills receivable / bills payable are eliminated, so that the Consolidated Balance Sheet shows the net asset position of the group vis-a-vis third parties.***
7. ***Degree of control depends upon holding of equity shares only.***

Students should note the following Tables carefully



Forms and Techniques

Forms

According to the Companies (Accounts) Rule 6, 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.

Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

Techniques

Different techniques are available for calculating minority interest; capital profit; revenue profit; and post-acquisition reserve; etc. Some of the techniques are given below :

(1) Calculations shown through control charts as working notes outside the Consolidted Balance Sheet.
(2) Calculations shown in a rough way as working notes outside the Consolidated Balance Sheet.

The first technique is suitable for complicated problems and it is less time consuming. Therefore, we have adapted this technique for its comprehensive character.
The second technique is not suitable for complicated problems and it is very time consuming and chances of errors are too much.

Illustration 1

The following are the summarised Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31.12.2015 :

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		5,00,000	1,00,000
(b) Reserves and Surplus — Profit and Loss Account		55,000	40,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(b) Trade Payables — Sundry Creditors		20,000	35,000
TOTAL		5,75,000	1,75,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Land		1,00,000	40,000
Building		1,00,000	50,000
(b) Non-current Investments — 8,000 Equity Shares of S Ltd.		1,25,000	—
(2) Current Assets :			
(a) Inventories — Stock		90,000	30,000
(b) Trade Receivables — Sundry Debtors		40,000	30,000
(c) Cash and Cash Equivalents — Cash in Hand		1,20,000	25,000
TOTAL		5,75,000	1,75,000

H Ltd. acquired shares in S Ltd. on 1.1.2015 when S Ltd. had ₹ 25,000 in Profit and Loss Account. No dividend has been declared by S Ltd. in 2015. You are required to prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31.12.2015.

Solution

(1) Degree of Control = $\dfrac{\text{8,000 Shares}}{\text{10,000 Shares}}$ = 4/5th ; Minority = 1/5th

> ***In our previous examples, minority interest, capital profit, goodwill / capital reserve have been calculated in rough fashion. With the help of control charts, we can easily calculate all the above items for the preparation of Consolidated Balance Sheet. Generally, three control charts are prepared as under:***

(1) **Control Chart A** : From the Balance Sheet of subsidiary company for calculating capital profit, post-acquisition profit, post-acquisition reserve, minority interest, etc;
(2) **Control Chart B** : For calculating goodwill or capital reserve; and
(3) **Control Chart C** : For addition of other assets and liabilities

Calculations by Control Charts are shown below :

Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit				
Pre-acquisition Profit		25,000	20,000	5,000
(b) Post-acquisition Profit				
As per Balance Sheet		40,000		
Less: Pre-acquisition Profit		25,000		
		15,000	12,000	3,000
(c) Share Capital		1,00,000		
Less : Minority Interest (1/5)		20,000		20,000
		80,000		
Adjusted in Control Chart B		80,000		
Minority Interest				28,000

Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		1,25,000
Less: Capital Profit (Chart A)	20,000	
Less: Face Value of Shares held	80,000	1,00,000
Goodwill		25,000

Control Chart C : Other Assets and Liabilities

Particulars	Land	Buildings	Stock	S/Debtors	Cash	S/Creditors	P & L A/c
H Ltd.	1,00,000	1,00,000	90,000	40,000	1,20,000	20,000	55,000
S Ltd.	40,000	50,000	30,000	30,000	25,000	35,000	12,000
	1,40,000	1,50,000	1,20,000	70,000	1,45,000	55,000	67,000

Calculations in Rough Fashion

(i) Minority Interest	₹
Share Capital	1,00,000
Profit & Loss A/c	40,000
	1,40,000
1/5 of ₹ 1,40,000 = ₹ **28,000**	

(ii) Profit and Loss Account	₹
H Ltd.	55,000
S Ltd. 4/5 of (₹ 40,000 – ₹ 25,000)	12,000
	67,000

(ii) Goodwill / Capital Reserve	₹
Intrinsic value of 8,000 shares on the date of purchase :	
Share Capital	1,00,000
Profit & Loss A/c	25,000
	1,25,000
₹ 1,25,000 / 10,000 × 8,000	1,00,000
Less: Cost of investments	1,25,000
Goodwill (Cost of Control)	25,000

(iv) Other Assets and Liabilities

Particulars	Land	Buildings	Stock	S/Debtors	Cash	Creditors	P & L A/c
H Ltd.	1,00,000	1,00,000	90,000	40,000	1,20,000	20,000	55,000
S Ltd.	40,000	50,000	30,000	30,000	25,000	35,000	12,000
	1,40,000	1,50,000	1,20,000	70,000	1,45,000	55,0000	67,000

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus	(2)	67,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	28,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		
(a) Trade Payables	(4)	55,000
TOTAL		6,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,90,000
(ii) Intangible Assets	(5)	25,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,20,000
(c) Trade Receivables	(7)	70,000
(d) Cash and Cash Equivalents	(8)	1,45,000
TOTAL		6,,50,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
50,000 Equity Shares of ₹ 10 each fully paid	5,00,000

(2) Reserve and Surplus

Particulars	₹
Profit and Loss Account (Chart 'C')	67,000

(3) Minority Interest

Particulars	₹
(Chart 'A')	28,000

(4) Trade Payables

Particulars	₹
Sundry Creditors (Chart 'C')	55,000

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Land (Chart 'C')	1,40,000
Building (Chart 'C')	1,50,000
	2,90,000
Intangible Assets :	
Goodwill (Chart 'B')	25,000

(6) Inventories

Particulars	₹
Stock (Chart 'C')	1,20,000

(7) Trade Receivables

Particulars	₹
Sundry Debtors (Chart 'C')	70,000

(8) Cash and Cash Equivalents

Particulars	₹
Cash in hand (Chart 'C')	1,45,000

Illustration 2

From the two Balance Sheets of H Ltd. and S Ltd., prepare a Consolidated Balance Sheet.

Balance Sheets of H Ltd. S Ltd. as at . . .

Particulars	Note No.	H Ltd. (₹)	S ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		1,20,000	30,000
(b) Reserves and Surplus — General Reserve		25,000	6,000
Profit and Loss Account		12,000	9,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		15,000	5,000
TOTAL		1,72,000	50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Building at Cost		72,000	25,000
Plant and machinery (Net)		30,000	10,000
(b) Non-current Investments — 2,000 Equity Shares of S Ltd. of ₹ 10 each		25,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		18,000	3,000
(c) Trade Receivables — Debtors		22,000	7,000
(d) Cash and Cash Equivalents — Bank		5,000	5,000
TOTAL		1,72,000	50,000

When H Ltd. acquired 2,000 shares in S Ltd., the latter company had reserves amounting to ₹ 5,000 — none of which has been distributed since then.

Solution **Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at . . .**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	1,20,000
(b) Reserves and Surplus	(2)	43,667
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	15,000
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables		20,000
TOTAL		1,98,667

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	1,37,000
(ii) Intangible Assets	(5)	1,667
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	21,000
(c) Trade Receivables	(7)	29,000
(d) Cash and Cash Equivalents	(8)	10,000
TOTAL		1,98,667

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
12,000 Equity Shares of ₹ 10 each fully paid	1,20,000
(2) Reserve and Surplus	
General Reserve (W.N. 6)	25,667
Profit and Loss Account (W.N. 5)	18,000
	43,667
(3) Minority Interest	
Chart ('A')	15,000
(4) Trade Payables	
Sundry Creditors	20,000

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Building (Chart 'C' – W.N. 4)	97,000
Plant and Machinery (Chart 'C' – W.N. 4)	40,000
	1,37,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	1,667
(6) Inventories	
Stock (Chart 'C' – W.N. 4)	21,000
(7) Trade Receivables	
Sundry Debtors (Chart 'C' – W.N. 4)	29,000
(8) Cash and Cash Equivalents	
Cash at Bank (Chart 'C' – W.N. 4)	10,000

Working Notes :

(1) Degree of Control = $\frac{2,000 \text{ Shares}}{3,000 \text{ Shares}}$ = 2/3rd ; Minority = 1/3rd

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (2/3)	Minority Interest (1/3)
(a) Capital Profit				
Pre-acquisition General Reserve		5,000		
		5,000	3,333	1,667
(b) Post-acquisition Profit				
Profit as per Balance Sheet		9,000		
Less: Pre-acquisition Profit		Nil		
		9,000	6,000	3,000
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		6,000		
Less: Pre-acquisition General Reserve (a)		5,000		
		1,000	667	333
(d) Share Capital		30,000		
Less : Minority Interest		10,000		10,000
		20,000		
Adjusted in Control Chart B		20,000		
Minority Interest				15,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		25,000
Less: Capital Profit	3,333	
Less: Face Value of Shares held	20,000	23,333
Goodwill		1,667

(4) Control Chart C : Other Assets and Liabilities

Particulars	Building	Plant and Machinery	Stock	Debtors	Bank	Creditors
H Ltd.	72,000	30,000	18,000	22,000	5,000	15,000
S Ltd.	25,000	10,000	3,000	7,000	5,000	5,000
	97,000	40,000	21,000	29,000	10,000	20,000

(5) Profit and Loss Account	₹	**(6) General Reserve**	₹
H Ltd.	12,000	H Ltd.	25,000
Share from S Ltd.	6,000	Share from S Ltd.	667
	18,000		25,667

Some Special Adjustments

(1) Unrealised Profit on Trading Stock

If the holding company and its subsidiary trade with one another, the goods bought at a profit from one company may appear as unsold stock in the Balance Sheet of another, if the entire quantity is not sold. In the Consolidated Balance Sheet, the aggregate stock of the holding company and its subsidiary is to be stated at a cost. But in this case, the cost to the buying company includes an element of profit earned by the selling company. From the viewpoint of the group, it should be ensured that no unrealised profit enters into group accounts. Therefore, it would be wrong to account for this profit until the goods had been sold outside the group. The unrealised profit on inter-group stocks, still held, must be computed and should be cancelled out. It should be deducted from the consolidated profit as well as from the aggregate stock valuation in the Consolidated Balance Sheet. The above adjustment also holds good when the subsidiary company is a wholly-owned subsidiary.

AS 21 — Para 17
Intragroup balances and 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.

Illustration 3

Following are the Balance Sheets of R Ltd. and S Ltd. as at 31.12.2015 :

Balance Sheets of R Ltd. S Ltd. . . .

Particulars	Note No.	R Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		4,00,000	1,50,000
(b) Reserves and Surplus : General Reserve		50,000	40,000
Profit and Loss Account		30,000	25,000

(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities : (a) Long-term Borrowings — 12% Debenture (Secured)		2,00,000	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		—	—
(c) Other Current Liabilities		3,20,000	2,85,000
TOTAL		10,00,000	5,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		5,00,000	2,40,000
(b) Non-current Investments — 15,000 Equity Shares in S Ltd. (acuired on 1.1.2015)		2,00,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories — Purchased from R ltd.		—	10,000
(c) Other current assets		3,00,000	2,50,000
TOTAL		10,00,000	5,00,000

Prepare a Consolidated Balance Sheet as at 31.12.2015, assuming that :

(a) S Ltd.'s General Reserve and Profit and Loss Account stood at ₹ 25,000 and ₹ 10,000 respectively on 1.1.2015 and,

(b) R Ltd. sells goods at a profit of 25% on cost.

Solution

Consolidated Balance Sheet of R Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus	(2)	1,08,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	Nil
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(4)	2,00,000
(5) Current Liabilities :		—
(c) Other Current Liabilities	(5)	6,05,000
TOTAL		13,13,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	7,40,000
(ii) Intangible Assets	(6)	15,000
(2) Current Assets :		
(a) Other Current Assets	(7)	5,58,000
TOTAL		13,13,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
40,000 Equity Shares of ₹ 10 each fully paid	4,00,000

(2) Reserve and Surplus

General Reserve (Chart 'C' – W.N. 4)	65,000
Profit and Loss Account (Chart 'C' – W.N. 4)	43,000
	1,08,000

(3) Minority Interest

(Chart 'A' – W.N. 2)	Nil

(4) Long-term Borrowings

Particulars	₹
Secured :	
12% Debentures	2,00,000

(5) Other Current Liabilities

(Chart 'A' – W.N. 4)	6,05,000

(6) Fixed Assets

Tangible Assets :	
Land and Building (Chart 'C' – W.N. 4)	7,40,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	15,000

(7) Other Current Assets

(Chart 'C' – W.N. 4)	5,58,000

Working Notes :

(1) Degree of Control = $\frac{15{,}000 \text{ Shares}}{15{,}000 \text{ Shares}}$ = 100% ; Minority Interest = Nil

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	R Ltd.'s Share (100%)	Minority Interest (Nil)
(a) Capital Profit				
1. Pre-acquisition Profit		10,000		
2. Pre-acquisition General Reserve		25,000		
		35,000	35,000	Nil
(b) Post-acquisition Profit				
Profit as per Balance Sheet		25,000		
Less: Pre-acquisition Profit		10,000		
		15,000	15,000	Nil
(c) Post-acquisition General Reserve				
Reserve as per Balance Sheet		40,000		
Less: Pre-acquisition General Reserve		25,000		
		15,000	15,000	Nil
(d) Equity Share Capital		1,50,000		
Adjusted in Control Chart B		1,50,000		
Minority Interest				Nil

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		2,00,000
Less: Capital Profit	35,000	
Less: Face Value of Shares held	1,50,000	1,85,000
Goodwill		15,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Building	Other Current Assets	Other Current Liabilities	General Reserve	Profit / Loss Account
R Ltd.	5,00,000	3,00,000	3,20,000	50,000	30,000
S Ltd.	2,40,000	2,60,000	2,85,000	15,000	15,000
	—	5,60,000	—	—	45,000
Less: Unrealised Profit on Stock (Note 5)	—	2,000	—	—	2,000
	7,40,000	5,58,000	6,05,000	65,000	43,000

(5) Unrealised profit on stock = 25 / 125 × ₹ 10,000 = ₹ 2,000. R Ltd. is holding 100% equity shares of S Ltd. Therefore, the entire amount of ₹ 2,000 is to be provided for unrealised profit.

(2) Unrealised Profit on Fixed Assets

A member company may transfer fixed assets or stock which becomes fixed assets of the transferee company at a profit. In this case, a similar problem arises as that seen in connection with trading stock transfer. At the time of consolidation, unrealised profit should be deducted from consolidated profit as well as aggregate value of fixed assets.

(3) Revaluation of Assets

If the fixed assets of the subsidiary company are revalued at the time of acquisition of the controlling shares of the subsidiary company by the holding company, the effect of profit or loss on revaluation should be reflected in the Consolidated Balance Sheet. The assets are to appear at their revalued figures in the Consolidated Balance Sheet. If the revaluation is upward causing an increase in the book value of an asset, the same should be treated as a pre-acquisition profit. The total revaluation profit will be apportioned and will be used in calculating goodwill / capital reserve and minority interest. The holding company's share of the revaluation profit will be taken to 'investment in subsidiary company' which, in effect, will reduce the cost of control on value of goodwill or capital reserve. If the revaluation results in a loss, the cost of control on value of goodwill or capital reserve will be increased.

If an asset is revalued, the compounding depreciation adjustment is also to be considered. If the revaluation results in an increase, the depreciation that has already been charged seems to be undercharged and the amount of extra depreciation is treated as revenue loss. This should be deducted from the Profit and Loss Account of the subsidiary. Conversely, when there is a downward revaluation, the depreciation that has already been provided seem to be overcharged. The amount of extra depreciation is to be written-back and considered as a revenue profit. This should be added with the Profit and Loss Account of the subsidiary company.

Illustration 4

The following are the Balance Sheets of X Ltd. and Y Ltd. as at 31.12.2015 : (figures in ₹)

Balance Sheets of X Ltd. and Y Ltd. as at 31st December, 2015

Particulars	Note No.	X Ltd. (₹)	Y Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		4,00,000	1,00,000
(b) Reserves and Surplus — Profit and Loss Account		50,000	20,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Other Current Liabilities — External Liabilities		7,50,000	4,80,000
TOTAL		12,00,000	6,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Equipment		2,50,000	95,000
(b) Non-current Investments — 9,000 Equity Shares in Y Ltd. (acquired on 1.1.2015)		1,40,000	—
(2) Current Assets :			
(a) Other current assets		8,10,000	5,05,000
TOTAL		12,00,000	6,00,000

On January 1, 2015, Profit and Loss Account of Y Ltd. showed a credit balance of ₹ 8,000 and equipment of Y Ltd. was revalued by X Ltd. at 20% above its book value of ₹ 1,00,000 (but no such adjustment was effected in the books of Y Ltd.)

Prepare the Consolidated Balance Sheet as at 31.12.2015.

Solution

Consolidated Balance Sheet of X Ltd. and its Subsidiary Y Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus	(2)	59,900
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	13,900
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Other Current Liabilities	(4)	12,30,000
TOTAL		17,03,800
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	3,64,000
(ii) Intangible Assets	(5)	24,800
(2) Current Assets :		
(a) Other Current Assets	(6)	13,15,000
TOTAL		17,03,800

Notes to Accounts :

Particulars	₹
(1) Share Capital	
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
40,000 Equity Shares of ₹ 10 each fully paid	4,00,000
(2) Reserve and Surplus	
Profit and Loss Account (Chart 'C' – W.N. 4)	59,900
(3) Minority Interest	
(Chart 'A' – W.N. 2)	13,900

Particulars	₹
(4) Other Current Liabilities	
External Liabilities (Chart 'C' – W.N. 4)	12,30,000
(5) Fixed Assets	
Tangible Assets :	
Equipment (Chart 'C' – W.N. 4)	3,64,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	24,800
(6) Other Current Assets	13,15,000

Working Notes :

(1) Degree of control $= \dfrac{9{,}000 \text{ Shares}}{10{,}000 \text{ Shares}} =$ 9/10th; Minority = 1 / 10th.

(2) Control Chart A : From the Balance Sheet of Y Ltd.

Proprietary Balances	Notes	Total (₹)	X Ltd.'s Share (9/10)	Minority Interest (1/10)
(a) Capital Profit				
1. Pre-acquisition Profit		8,000		
2. Revaluation Profit (₹ 1,20,000 – ₹ 1,00,000)		20,000		
		28,000	25,200	2,800
(b) Post-acquisition Profit				
Profit as per Balance Sheet		20,000		
Less: Pre-acquisition Profit		8,000		
		12,000		
Less: Depreciation	5	1,000		
		11,000	9,900	1,100

(c) Share Capital		1,00,000		
Less : Minority Interest (1/10)		10,000		10,000
		90,000		
Adjusted in Control Chart B		90,000		
Minority Interest				13,900

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		1,40,000
Less: Capital Profit	25,200	
Less: Face Value of Shares held	90,000	1,15,200
Goodwill		24,800

(4) Control Chart C : Other Assets and Liabilities

Particulars	Equipment	Other Current Assets	External Liabilities	Profit & Loss A/c
X Ltd.	2,50,000	8,10,000	7,50,000	50,000
Y Ltd.	95,000	5,05,000	4,80,000	9,900
	3,45,000			
Add: Revaluation Profit	20,000			
	3,65,000			
Less: Depreciation (Note 5)	1,000			
	3,64,000	13,15,000	12,30,000	59,900

(5) Depreciation : On 1.1.2015, the value of equipment of Y Ltd. was ₹ 1,00,000. On 31.12.2015, it has been shown in the Balance Sheet at ₹ 95,000. It means that in 2015, ₹ 5,000 depreciation has been charged (assuming that there was no sale of equipment). Therefore, the rate of depreciation = ₹ 5,000 / ₹ 1,00,000 × 100 = 5%. In 2015, depreciation should have been charged on ₹ 1,20,000 (on revalued figure). Therefore, the depreciation should have been ₹ 6,000 (5% of ₹ 1,20,000) but only ₹ 5,000 depreciation has been charged. Therefore, extra depreciation to be charged = ₹ 6,000 – ₹ 5,000 = ₹ 1,000.

Illustration 5

When O Ltd. purchased 24,000 equity shares in P Ltd. on 1.1.2015, P Ltd. had ₹ 22,500 in General Reserve and ₹ 37,500 (Dr.) in Profit and Loss Account. From their Balance Sheets on 31.12.2015 as below, prepare a Consolidated Balance Sheet:

Balance Sheets of O Ltd. and P Ltd. as at 31st December, 2016

Particulars	Note No.	O Ltd. (₹)	P Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share ₹ 10 each		7,50,000	3,00,000
(b) Reserves and Surplus : General Reserve		90,000	7,500
Profit and Loss Account		60,000	(67,500)
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		1,05,000	31,500
TOTAL		10,05,000	2,71,500
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		6,75,000	1,50,000
(b) Non-current Investments — 24,000 Equity Shares in P ltd.		2,10,000	—
(2) Current Assets :			
(a) Other current assets		1,20,000	1,21,500
TOTAL		10,05,000	2,71,500

Fixed assets standing in the books of P Ltd. ₹ 90,000 was considered worth ₹ 75,000 on the date of purchase of control. For the purpose of determining the value of shares 20% depreciation has been written-off since acquisition. Stock of O Ltd. includes ₹ 30,000 on which P Ltd. made ₹ 7,500 profit.

Solution

Consolidated Balance Sheet of O Ltd. and its Subsidiary P Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,50,000
(b) Reserves and Surplus	(2)	1,14,900
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	45,600
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	1,36,500
TOTAL		10,47,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	8,13,000
(ii) Intangible Assets		—
(2) Current Assets :		
(a) Other Current Assets	(6)	2,34,000
TOTAL		10,47,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
75,000 Equity Shares of ₹ 10 each fully paid	7,50,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve (Chart 'B' – W.N. 3)	6,000
General Reserve (W.N. 6)	78,000
Profit and Loss Account (W.N. 7)	30,900
	1,14,900

(3) Minority Interest

Particulars	₹
(Chart 'A' – W.N. 2)	45,600
(4) Trade Payables	
Sundry Creditors (W.N. 8)	1,36,500
(5) Fixed Assets	
Tangible Assets :	
Land and Building (W.N. 4)	8,13,000
(6) Other Current Assets (W.N. 5)	2,34,000

Working Notes :

(1) Degree of control $= \dfrac{24{,}000 \text{ Shares}}{30{,}000 \text{ Shares}}$ = 4/5th; Minority = 1/5th

(2) Control Chart A : From the Balance Sheet of P Ltd.

Proprietary Balances	Notes	Total (₹)	O Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit				
1. Pre-acquisition Profit		(37,500)		
2. Pre-acquisition General Reserve		22,500		
3. Revaluation Loss (₹ 90,000 – ₹ 75,000)		(15,000)		
		(30,000)	(24,000)	(6,000)

(b) Post-acquisition Profit				
Profit as per Balance Sheet		(67,500)		
Less: Pre-acquisition Profit (a)		(37,500)		
		(30,000)		
Add: Depreciation written-back	9	3,000		
		(27,000)	(21,600)	(5,400)
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		7,500		
Less: Pre-acquisition General Reserve		22,500		
		(15,000)	(12,000)	(3,000)
(d) Share Capital		3,00,000		
Less : Minority Interest (1/5)		60,000		60,000
		2,40,000		
Adjusted in Control Chart B		2,40,000		
Minority Interest				45,600

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		2,10,000
Less: Capital Profit	(24,000)	
Less: Face Value of Shares held	2,40,000	2,16,000
Capital Reserve (being negative)		(6,000)

(4) Land and Building	₹	**(6) General Reserve**	₹
O Ltd.	6,75,000	O Ltd.	90,000
P Ltd.	1,50,000	Share from P Ltd.	(12,000)
	8,25,000		78,000
Less: Revaluation Loss	15,000	**(7) Profit and Loss Account (Consolidated)**	
	8,10,000	O Ltd.	60,000
Add: Depreciation written-back	3,000	Share from P Ltd.	(21,600)
	8,13,000		38,400
(5) Other Current Assets		Less: Unrealised Profit on Stock	7,500
O Ltd.	1,20,000		30,900
P Ltd.	1,21,500	**(8) Sundry Creditors**	
	2,41,500	O Ltd.	1,05,000
Less: Unrealised Profit on Stock	7,500	P Ltd.	31,500
	2,34,000		1,36,500

(9) Depreciation to be added back :

Depreciation charged on ₹ 90,000 @ 20%	₹ 18,000
Depreciation to be charged on ₹ 75,000 @ 20%	₹ 15,000
Depreciation to be added back	₹ 3,000

Issue of Bonus Shares

Treatment of bonus shares issued by the subsidiary company will depend upon whether they are issued out of pre-acquisition profit or post-acquisition profit.

If the bonus shares are issued out of pre-acquisition profit, it will not have any effect on the Consolidated Balance Sheet. This is because it will cause decrease in the holding company's share of pre-acquisition profit and on the other hand paid-up value of the equity shares held by the holding company will be increased by the same amount. Therefore, the amount of goodwill or capital reserve will be the same. The portion of the bonus shares of the minority shareholders will be added to the minority interest.

If a subsidiary company issues bonus shares out of post-acquisition profit, it will have a direct effect on the Consolidated Balance Sheet. In such a situation, the holding company's share of revenue profit in the subsidiary company will be reduced and the paid-up value of the shares held by the holding company in its subsidiary will be increased because of the issue of bonus shares. This will reduce the value of goodwill or increase the value of capital reserve. The portion of the bonus shares of the minority interest will be added to the minority interest, as before.

Illustration 6

A Ltd. acquired 2,000 Equity Shares of ₹ 100 each in B Ltd. on 31.12.2014. The summarised Balance Sheets of the two companies as on 31.12.2015 were as follows :

Balance Sheets of A Ltd. and B Ltd. as at . . .

Particulars	Note No.	A Ltd. (₹)	B Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 100 each		8,00,000	2,50,000
(b) Reserves and Surplus : Reserves		3,00,000	50,000
Profit and Loss Account		1,00,000	1,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sundry Creditors		2,00,000	50,000
(c) Other Current Liabilities			
TOTAL		14,00,000	4,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		7,00,000	2,50,000
(b) Non-current Investments — 2,000 Equity Shares in B Ltd. at cost		3,00,000	—
(2) Current Assets :			
(a) Other current assets		4,00,000	2,00,000
TOTAL		14,00,000	4,50,000

B Ltd. had a credit balance of ₹ 50,000 in the Reserves and ₹ 20,000 in the Profit and Loss Account when A Ltd. acquired shares in B Ltd. B Ltd. issued bonus shares in the ratio of one for every five shares held out of the profits earned during 2015. This is not shown in the above Balance Sheet of B Ltd. Prepare a Consolidated Balance Sheet of A Ltd. and its subsidiary, as on 31.12.2015, giving all necessary workings.

Solution

Consolidated Balance Sheet of A Ltd. and its Subsidiary B Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	8,00,000
(b) Reserves and Surplus	(2)	4,24,000
(2) Share Application Money Pending Allotment :		—

(3) Minority Interest	(3)	80,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		—
(a) Trade Payables	(4)	2,50,000
TOTAL		15,54,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	9,50,000
(ii) Intangible Assets	(5)	4,000
(2) Current Assets :		
(a) Other Current Assets	(6)	6,00,000
TOTAL		15,54,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
8,000 Equity Shares of ₹ 100 each fully paid	8,00,000
(2) Reserve and Surplus	
Reserve (Chart 'C' – W.N. 4)	3,00,000
Profit and Loss Account (Chart 'C' – W.N. 4)	1,24,000
	4,24,000

(3) Minority Interest

Particulars	₹
(Chart 'A' – W.N. 2)	80,000
(4) Trade Payables	
Sundry Creditors	2,50,000
(5) Fixed Assets	
Tangible Assets :	
Plant and Machinery (Chart 'C' – W.N. 4)	9,50,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	4,000
(6) Other Current Assets (Chart 'C' – W.N. 4)	6,00,000

Working Notes :

(1) Degree of control $= \dfrac{2{,}000 \text{ Shares}}{2{,}500 \text{ Shares}} = 4/5\text{th}$; Minority = 1/5th

(2) Control Chart A : From the Balance Sheet of B Ltd.

Proprietary Balances	Notes	Total (₹)	A Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit				
1. Pre-acquisition Profit		20.000		
2. Pre-acquisition Reserve		50.000		
		70.000	56,000	14,000
(b) Post-acquisition Profit				
Profit as per Balance Sheet		1,00,000		
Less: Pre-acquisition Profit (a)		20,000		
		80,000		
Less: Bonus Share		50,000		
		30,000	24,000	6,000
(c) Post-acquisition Reserve				
Reserve as per Balance Sheet		50,000		
Less: Pre-acquisition Reserve		50,000		
		Nil	Nil	Nil
(d) Share Capital		2,50,000		
Add: Bonus Shares		50,000		
		3,00,000		
Less: Minority Interest (1/5)		60,000		60,000
		2,40,000		
Adjusted in Control Chart B		2,40,000		
Minority Interest				80,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		3,00,000
Less: Capital Profit	56,000	
Less: Face Value of Shares held	2,40,000	2,96,000
Goodwill		4,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	Plant and Machinery	Other Current Assets	Sundry Creditors	Reserve	P & L A/c
A Ltd.	7,00,000	4,00,000	2,00,000	3,00,000	1,00,000
B Ltd.	2,50,000	2,00,000	50,000	—	24,000
	9,50,000	6,00,000	2,50,000	3,00,000	1,24,000

(5) Preference Shares held by the Holding Company

When preference shares are issued by a subsidiary company and are held by the holding company (whether wholly or partly), it should be treated in the same way as equity shares. If the holding company acquires the preference shares at par, the cost of investment of the holding company cancels out of the shares shown on the Balance Sheet of the subsidiary. When the preference shares are acquired at a premium or a discount, the balance is carried to goodwill or capital reserve in the Consolidated Balance Sheet. The portion of the preference shares owned by the minority shareholders are added to minority interest.

(6) Debentures

The debentures of the holding company will appear in the liability side of the Consolidated Balance Sheet, just like equity or preference share capital. Debentures issued either by the holding company or the subsidiary and held by other should be cancelled out when they are acquired at par. When part of the debentures are held by the minority shareholders, it should appear in the liability side of the Consolidated Balance Sheet. The holding company's "investment in debentures in the subsidiary" will cancel out against the nominal value of debentures shown in the subsidiary company's Balance Sheet.

If the debentures are acquired at a premium or at a discount, the difference between cost and nominal value is adjusted against goodwill or capital reserve in the Balance Sheet.

Illustration 7

From the Balance Sheets and additional information given below, prepare a Consolidated Balance Sheet :

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 100 each		5,00,000	2,00,000
(b) Reserves and Surplus : General Reserve		60,000	40,000
Profit and Loss Account		30,000	10,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) 12% Debentures of ₹ 100 each (Secured)		—	1,00,000
(4) Current Liabilities :			
(a) Trade Payables :			
Creditors		40,000	25,000
Bills Payable		12,000	8,000
(b) Short-term Provisions		40,000	20,000
TOTAL		6,82,000	4,03,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		3,50,000	3,20,000
(b) Non-current Investments :			
Shares in S Ltd. (1,500 shares @ ₹ 120 each)		1,80,000	—
12% Debentures (400 Debentures @ ₹ 90 each)		36,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories — Stock		35,000	15,000
(c) Trade Receivables :			
Debtors		60,000	30,000
Bills Receivable		10,000	8,000
(d) Cash and cash equivalents — Cash in Hand		11,000	30,000
TOTAL		6,82,000	4,03,000

Additional information :

(i) When H Ltd. acquired the shares of S Ltd., the General Reserve and Profit and Loss Account of S Ltd. showed a balance of ₹ 30,000 and ₹ 4,000 (Dr.), respectively.

(ii) Creditors of S Ltd. include ₹ 10,000 for goods supplied by H Ltd. at a profit of 20% on sales. Half of the goods were still in stock on 31.12.2015.

(iii) The bills accepted by H Ltd. were all in favour of S Ltd.

(iv) Plant and Machinery were over-valued by ₹ 20,000.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus	(2)	1,07,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	57,500
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(4)	60,000
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(5)	67,000
(c) Other Current Liabilities		—
(d) Short-term Provisions	(6)	60,000
TOTAL		8,51,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(7)	6,50,000
(ii) Intangible Assets	(7)	21,500
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(8)	49,000
(c) Trade Receivables	(9)	90,000
(d) Cash and Cash Equivalents	(10)	41,000
TOTAL		8,51,500

Notes to Accounts :

(1) Share Capital

Particulars		₹
Authorised Capital :		
? Equity Shares of ? each		?
Issued, Subscribed and Paid-up Capital :		
5,000 Equity Shares of ₹ 100 each fully paid		5,00,000
(2) Reserve and Surplus		
General Reserve (W.N. 6)		67,500
Profit and Loss Account (W.N. 5)		39,500
		1,07,000
(3) Minority Interest		
(Chart 'A' – W.N. 2)		57,500
(4) Long-term Borrowings		
Secured		
12% Debentures	1,00,000	
Less: Held within the Group	40,000	60,000
(5) Trade Payables		
Creditors (Chart 'C' – W.N. 4)		55,000
Bills Payable (Chart 'C' – W.N. 4)		12,000
		67,000

(6) Short-term Provision

Particulars	₹
H. Ltd	40,000
S. Ltd	20,000
	60,000
(7) Fixed Assets	
Tangible Assets :	
Plant and Machinery (Chart 'C' – W.N. 4)	6,50,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	21,500
(8) Inventories	
Stock (Chart 'C' – W.N. 4)	49,000
(9) Trade Receivables	
Debtors (Chart 'C' – W.N. 4)	80,000
Bills Receivables (Chart 'C' – W.N. 4)	10,000
	90,000
(10) Cash and Cash Equivalents	
Cash (Chart 'C' – W.N. 4)	41,000

Tutorial Note : Debentures are liabilities to outside parties and will be cancelled only to the extent of debentures held in the group.

Working Notes :

(1) Degree of Control = $\frac{1{,}500 \text{ Shares}}{2{,}000 \text{ Shares}}$ = 3/4th; Minority = 1/4th

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
1. Pre-acquisition Profit		(4,000)		
2. Pre-acquisition General Reserve		30,000		
3. Revaluation Loss		(20,000)		
		6,000	4,500	1,500
(b) Post-acquisition Profit				
Profit as per Balance Sheet		10,000		
Add: Pre-acquisition Loss		4,000		
		14,000	10,500	3,500
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		40,000		
Less: Pre-acquisition General Reserve		30,000		
		10,000	7,500	2,500
(d) Share Capital		2,00,000		
Less : Minority Interest (1/4)		50,000		50,000
		1,50,000		
Adjusted in Control Chart B		1,50,000		
Minority Interest				57,500

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments :		
In Equity Shares	1,80,000	
In Debentures	36,000	2,16,000
Less: Capital Profit		4,500
		2,11,500
Less: Face Value of Shares held	1,50,000	
Less: Face Value of Debentures held	40,000	1,90,000
Goodwill		21,500

(4) Control Chart C : Other Assets and Liabilities

Particulars	Plant and Machinery	Stock	Debtors	B/R	Cash	Creditors	Bills Payable
H Ltd.	3,50,000	35,000	60,000	10,000	11,000	40,000	12,000
S Ltd.	3,20,000	15,000	30,000	8,000	30,000	25,000	8,000
	6,70,000	50,000	90,000	18,000	41,000	65,000	20,000
Less: Revaluation Loss	20,000	—	—	—	—	—	—
Less: Unrealised Profit	—	1,000	—	—	—	—	—
Less: Mutual Indebtedness	—	—	10,000	—	—	10,000	—
Less: Mutual Acceptances	—	—	—	8,000	—	—	8,000
	6,50,000	49,000	80,000	10,000	41,000	55,000	12,000

(5) Profit and Loss Account	₹	**(6) General Reserve**	₹
H Ltd.	30,000	H Ltd.	60,000
Share from S Ltd. (Chart A)	10,500	Share from S Ltd. (Chart A)	7,500
	40,500		67,500
Less: Unrealised Profit on Stock (Note 8)	1,000		
	39,500		

(8) Unrealised Profit on Stock = 1/2 (20% of ₹ 10,000) = ₹ 1,000.
(9) For lack of information, no effect has been given in CBS for depreciation on **Revaluation Loss**.

(7) Inter-company Dividends

Holding company owns majority of the shares of its subsidiary. When a dividend is paid out of profit of the subsidiary company, the holding company is likely to receive a majority portion of it as a shareholder. It should be noted that such dividends may be paid out of pre-acquisition profit or post-acquisition profit. The accounting treatment in the books of the holding company will vary accordingly.

Dividend Paid Out of Pre-acquisition Profit by the Subsidiary Company

Care is needed in the treatment of any dividend received by the holding company from its subsidiary which come out of pre- acquisition profits. Such dividend should be treated as a return of capital to the holding company, since it transfers to the holding company part of the net assets in the subsidiary company that have been paid for. In this situation, the correct accounting treatment is to deduct such dividend from the cost of investment in the subsidiary for calculating goodwill or capital reserve.

Points to Remember

1. If such dividend has wrongly been credited to the Profit and Loss Account of the holding company, then it should be rectified. For rectification, the amount of dividend received by the holding company out of pre-acquisition profit is to be deducted from the Profit and Loss Account of the holding company as well as from the cost of investment in the shares of subsidiary. For better understanding of the accounting treatment, observe the following :

Wrong Entry		Correct Entry	
(a) Bank Account	Dr.	(a) Bank Account	Dr.
To Dividend Received Account		To Dividend Received Account	
(b) Dividend Received Account	Dr.	(b) Dividend Received Account	Dr.
To Profit and Loss Account		To Investment in Shares of Subsidiary Co. Account	

2. No adjustment is required if such dividend has already been correctly treated in the books of the holding company.

Dividend Paid Out of Post-acquisition Profit by the Subsidiary Company

Dividend received by the holding company from a subsidiary out of post-acquisition profit is treated as investment income and credited to the Profit and Loss Account of the holding company.

It should be noted that any ***interim dividend*** paid by the subsidiary company is also treated in the books of the holding company in the same manner as discussed above.

Illustration 8

H Ltd. purchased control of S Ltd. on 1.1.2015. The following are the Balance Sheets of H Ltd. and S Ltd. as at 31.12.2015:

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		12,00,000	6,00,000
(b) Reserves and Surplus : General Reserve		1,20,000	1,00,000
Profit and Loss Account		2,00,000	2,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sundry Creditors		2,00,000	1,60,000
TOTAL		17,20,000	10,60,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		2,20,000	2,80,000
Plant and machinery		4,00,000	3,60,000
(b) Non-current Investments — 45,000 Equity Shares in S Ltd. at cost		6,75,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories — Stock-in-trade		90,000	40,000
(c) Trade Receivables — Sundry Debtors		1,00,000	1,80,000
(d) Cash and Cash Equivalents — Cash		2,35,000	2,00,000
TOTAL		17,20,000	10,60,000

On 1.1.2015 S Ltd. had ₹ 1,00,000 in General Reserve and ₹ 1,20,000 (Cr.) in Profit and Loss Account. In July 2015, 10% dividend was paid by S Ltd. for 2014. Dividend received from S Ltd. was credited to Profit and Loss Account by H Ltd. Debtors of S Ltd. includes ₹ 25,000 due from H Ltd. Prepare Consolidated Balance Sheet as on 31st December, 2015.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	12,00,000
(b) Reserves and Surplus	(2)	3,80,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	2,25,000
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	3,35,000
TOTAL		21,40,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	12,60,000
(ii) Intangible Assets	(5)	60,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,30,000
(c) Trade Receivables	(7)	2,55,000
(d) Cash and Cash Equivalents	(8)	4,35,000
TOTAL		21,40,000

Notes to Accounts :

Particulars	₹	Particulars	₹
(1) Share Capital		**(5) Fixed Assets**	
Authorised Capital :		*Tangible Assets :*	
? Equity Shares of ? each	?	Land and Building (Chart 'C' – W.N. 4)	5,00,000
Issued, Subscribed and Paid-up Capital :		Plant and Machinery (Chart 'C' – W.N. 4)	7,60,000
1,20,000 Equity Shares of ₹ 10 each fully paid	12,00,000		12,60,000
(2) Reserve and Surplus		*Intangible Assets :*	
General Reserve	1,20,000	Goodwill (Chart 'B' – W.N. 3)	60,000
Profit and Loss Account (W.N. 5)	2,60,000	**(6) Inventories**	
	3,80,000	Stock (Chart 'C' – W.N. 4)	1,30,000
(3) Minority Interest		**(7) Trade Receivables**	
(Chart 'A' – W.N. 2)	2,25,000	Sundry Debtors (Chart 'C' – W.N. 4)	2,55,000
(5) Trade Payables		**(8) Cash and Cash Equivalents**	
Sundry Creditors (Chart 'C' – W.N. 4)	3,35,000	Cash at Bank (Chart 'C' – W.N. 4)	4,35,000

Working Notes :

(1) Degree of Control = $\frac{45,000 \text{ Shares}}{60,000 \text{ Shares}}$ = 3/4th ; Minority = 1/4th

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances		Notes	Total (₹)	H Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit					
1. Pre-acquisition Profit	1,20,000				
Less : 10% Dividend for 2014	60,000		60,000		
2. Pre-acquisition General Reserve			1,00,000		
			1,60,000	1,20,000	40,000
(b) Post-acquisition Profit					
Profit as per Balance Sheet			2,00,000		
Less: Pre-acquisition Profit			60,000		
			1,40,000	1,05,000	35,000
(c) Post-acquisition General Reserve					
General Reserve as per Balance Sheet			1,00,000		
Less: Pre-acquisition General Reserve			1,00,000		
			Nil	Nil	Nil
(d) Share Capital			6,00,000		
Less : Minority Interest (1/4)			1,50,000		1,50,000
			4,50,000		
Adjusted in Control Chart B			4,50,000		
	Minority Interest				2,25,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		6,75,000
Less: Capital Profit (Chart A)	1,20,000	
Less: Dividend of 2014 (Note 6)	45,000	
Less: Face Value of Shares held	4,50,000	6,15,000
Goodwill		60,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	L & B	P & M	Stock	Sundry Debtors	Bank	Sundry Creditors
H Ltd.	2,20,000	4,00,000	90,000	1,00,000	2,35,000	2,00,000
S Ltd.	2,80,000	3,60,000	40,000	1,80,000	2,00,000	1,60,000
				2,80,000		3,60,000
Less: Mutual Indebtedness	—	—	—	25,000	—	25,000
	5,00,000	7,60,000	1,30,000	2,55,000	4,35,000	3,35,000

(5) Profit and Loss Account (Consolidated)

	₹
H Ltd.	2,00,000
Less: Dividend of 2014 wrongly credited to P&L Account (Note 6)	45,000
	1,55,000
Add: Share of Post-acquisition Profit from S Ltd.	1,05,000
	2,60,000

(6) In July 2015, H Ltd. received ₹ 45,000 (3/4 of ₹ 60,000) as dividend from S Ltd. This dividend was paid from pre-acquisition profit of ₹ 1,20,000. This dividend should have been credited to Investment in the shares of S Ltd. Account but wrongly it was credited to Profit and Loss Account of H Ltd. Therefore, for rectification, ₹ 45,000 is to be deducted from the cost of investments as well as from Profit and Loss Account of H Ltd.

Illustration 9

The Balance Sheet of Howrah Ltd. and Sibpur Ltd. as on 31.03.2016 were as follows :

Balance Sheets of Howrah Ltd. and Sibpur Ltd. as at 31st March, 2016

Particulars	Note No.	Howrah Ltd.t (₹)	Sibpur Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 100 each		6,00,000	2,50,000
(b) Reserves and Surplus : General Reserve		1,00,000	60,000
Profit and Loss Account		1,50,000	90,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Creditors		70,000	60,000
(b) Other Current Liabilities — Income tax		60,000	70,000
TOTAL		9,80,000	5,30,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Machinery		1,50,000	1,08,000
Vehicle		1,30,000	50,000
Furniture		50,000	30,000
(ii) Intangible Assets — Goodwill		60,000	40,000
(b) Non-current Investments — 2,000 Equity Shares in Sibpur Ltd. (at cost)		3,80,000	—
(2) Current Assets :			
(a) Inventories — Stock		70,000	1,40,000
(b) Trade Receivables — Debtors		60,000	1,00,000
(c) Cash and Cash Equivalents — Bank		80,000	62,000
TOTAL		9,80,000	5,30,000

Additional Information :

(i) Howrah Ltd. acquired 2,000 equity shares of Sibpur Ltd. on 01.04.2015.

(ii) The Profit and Loss Account of Sibpur Ltd. had a credit balance of ₹ 30,000 and that of General Reserve ₹ 50,000 on the date of acquisition.

(iii) On 1.6.2015 Sibpur Ltd. declared a dividend out of its pre-acquisition profits @ 12% on its share capital. Howrah Ltd. credited the same to its Profit and Loss Account.

(iv) Sibpur Ltd. owned ₹ 20,000 for purchase of stock from Howrah Ltd. The entire stock is held on 31.03.2016. Howrah Ltd. made profit of 25% on cost.

(v) Machinery standing in the books of Sibpur Ltd. at ₹ 1,20,000 on the date of acquisition of shares, were revalued at ₹ 1,44,000.

Prepare a consolidated Balance Sheet of Howrah Ltd, and Sibpur Ltd. on 31.03.2016.

Solution

Consolidated Balance Sheet of Howrah Ltd. and its Subsidiary Sibpur Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,00,000
(b) Reserves and Surplus	(2)	3,00,080
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	84,320
(4) Non-current Liabilities :		—
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	1,10,000
(c) Other Current Liabilities		—
(d) Short-term Provisions	(5)	1,30,000
TOTAL		12,24,400
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	5,39,600
(ii) Intangible Assets	(6)	1,96,800
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	2,06,000
(c) Trade Receivables	(8)	1,40,000
(d) Cash and Cash Equivalents	(9)	1,42,000
TOTAL		12,24,400

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
6,000 Equity Shares of ₹ 100 each fully paid	6,00,000

(6) Fixed Assets

Particulars	₹
Tangible Assets :	
Machinery (Chart 'C' – W.N. 4)	2,79,600
Vehicle (Chart 'C' – W.N. 4)	1,80,000
Furniture (Chart 'C' – W.N. 4)	80,000
	5,39,600

(2) Reserve and Surplus			
General Reserve (W.N. 8)	1,08,000	*Intangible Assets :*	
Profit and Loss Account (W.N. 5)	1,92,080	Goodwill (Chart 'B' – W.N. 3 & Chart 'C' – W.N. 4)	1,96,800
	3,00,080	**(7) Inventories**	
(3) Minority Interest		Stock (Chart 'C' – W.N. 4)	2,06,000
(Chart 'A' – W.N. 2)	84,320	**(8) Trade Receivables**	
(4) Trade Payables		Debtors (Chart 'C' – W.N. 4)	1,40,000
Creditors (Chart 'C' – W.N. 4)	1,10,000	**(9) Cash and Cash Equivalents**	
(5) Short-term Provisions		Cash at Bank (Chart 'C' – W.N. 4)	1,42,000
Income-tax :			
Howrah Ltd	60,000		
Sibpur Ltd	70,000		
	1,30,000		

Working Notes :

(1) Degree of Control = $\frac{2{,}000 \text{ Shares}}{2{,}500 \text{ Shares}}$ = 4/5th; Minority = 1/5th

(2) Control Chart A : From the Balance Sheet of Sibpur Ltd.

Proprietary Balances		Notes	Total (₹)	Howrah Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit					
1. Pre-acquisition Profit			30,000		
Less: 12% Dividend for 2014-15			(30,000)		
2. Pre-acquisition General Reserve			50,000		
3. Revaluation Profit (₹ 1,44,000 – 1,20,000)			24,000		
			74,000	59,200	14,800
(b) Post-acquisition Profit					
Profit as per Balance Sheet			90,000		
Less: Balance of Pre-acquisition Profit			Nil		
			90,000		
Less: Depreciation		(9)	2,400		
			87,600	70,080	17,520
(b) Post-acquisition Reserve					
General Reserve as per Balance Sheet	60,000				
Less: Pre-acquisition General Reserve	50,000		10,000	8,000	2,000
(d) Share Capital			2,50,000		
Less : Minority Interest (1/5)			50,000	—	50,000
			2,00,000		
Adjusted in Control Chart B			2,00,000		
	Minority Interest		Nil		84,320

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

		₹	₹
Cost of Investments			3,80,000
Less: Capital Profit		59,200	
Less: Dividend of 2014-15 (4/5 of ₹ 30,000)		24,000	83,200
			2,96,800
Less: Face Value of Shares held			2,00,000
	Goodwill		96,800

(4) Control Chart C : Other Assets and Liabilities

Particulars	Goodwill	Machinery	Vehicles	Furniture	Stock	Debtors	Bank	Creditors
Howrah Ltd.	60,000	1,50,000	1,30,000	50,000	70,000	60,000	80,000	70,000
Sibpur Ltd.	40,000	1,08,000	50,000	30,000	1,40,000	1,00,000	62,000	60,000
Consolidation Goodwill	96,800	—	—	—	—	—	—	—
	1,96,800	2,58,000	1,80,000	80,000	2,10,000	1,60,000	1,42,000	1,30,000
Add: Revaluation Profit		24,000						
		2,82,000						
Less: Under Depreciation		2,400						
		2,79,600						
Less: Unrealised Profit on Stock (Note 6)					4,000			
Less: Mutual Indebtedness						20,000		20,000
					2,06,000	1,40,000		1,10,000

(5) Profit and Loss Account

		₹
Howrah Ltd.'s Profit Balance		1,50,000
Less:	Dividend of 2014-15 wrongly credited to Profit and Loss A/c (4/5 of ₹ 30,000)	24,000
		1,26,000
Less:	Untrealised Profit on Stock	4,000
		1,22,000
Add:	Share of Profit from Sibpur Ltd.	70,080
		1,92,080

(6) Unrealised Profit on Unsold Stock

Let, Cost = 100
Profit 25% = 25
Selling Price = 125

Unrealised Profit = 25 / 125 x ₹ 20,000 = ₹ **4,000**

(7) Income Tax

Howrah Ltd.	60,000
Sibpur Ltd.	70,000
	1,30,000

(8) General Reserve

Howrah Ltd.	1,00,000
Share from Sibpur Ltd.	8,000
	1,08,000

(9) Depreciation Under Charged on Machinery

Depreciation charged during the year (1,20,000 – 1,08,000) = ₹ 12,000
Rate of Depreciation = (12,000 / 1,20,000) x 100 = 10%.. Therefore,
Depreciation under charged = 10% (1,44,000 – 1,20,000) = ₹ **2,400.**

Illustration 10

The following are the Balance Sheet of H Ltd and its subsidiary S Ltd as on 31st March, 2016 :

Balance Sheets of H Ltd. and S Ltd. as at 31st March, 2016

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity shares of ₹ 100 each		10,00,000	8,00,000
(b) Reserves and Surplus : General Reserve		2,00,000	2,00,000
Profit and Loss Account		4,00,000	3,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sundry Creditors		—	1,00,000
(c) Other Current Liabilities		2,00,000	1,00,000
TOTAL		18,00,000	15,00,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		5,00,000	4,00,000
(b) Non-current Investments — 3,000 Equity Shares of S Ltd. (at cost)		5,00,000	—
(2) Current Assets :			
(a) Inventories		2,00,000	1,00,000
(b) Trade Receivables		1,00,000	—
(c) Other current assets		5,00,000	10,00,000
TOTAL		18,00,000	15,00,000

Additional information :

(i) H Ltd acquired 3,000 shares in S Ltd on 1.4.2015 when the Reserve and Surplus of S Ltd was as under : (a) General Reserve — ₹ 5,00,000; (b) Profit and Loss Account (Cr.) — ₹ 2,00,000.

(ii) On 1.10.2014 S Ltd issued 3 fully paid-up shares for every 5 shares held, as bonus out of pre-acquisition Reserve.

(iii) On 30.6.2014 S Ltd declared 20% dividend out of pre-acquisition profit and H Ltd credited the receipt of dividend to its Profit and Loss Account.

(iv) S Ltd owed H Ltd on 31.3.2016 ₹ 1,00,000 for purchase of stock from H Ltd. The entire stock is held by S Ltd on 31.3.2016. H Ltd made a profit of 25% on cost.

(v) H Ltd transferred for cash payment a Machine to S Ltd for ₹ 80,000. The cost of the Machine to H Ltd was ₹ 60,000.

Prepare Consolidated Balance Sheet as at 31.03.2016. Depreciation on Machinery is to be ignored.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus	(2)	8,40,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	5,20,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		—
(a) Other Current Liabilities	(4)	3,00,000
TOTAL		26,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	8,80,000
(2) Current Assets :		
(a) Other Current Assets	(6)	17,80,000
TOTAL		26,60,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 100 each fully paid	10,00,000
(2) Reserve and Surplus	
Capital Reserve (Chart 'B' – W.N. 3)	2,20,000
General Reserve	2,00,000
Profit and Loss Account (W.N. 5)	4,20,000
	8,40,000

(3) Minority Interest

Particulars	₹
(Chart 'A' – W.N. 2)	5,20,000
(4) Other Current Liabilities	
(Chart 'C' – W.N. 4)	3,00,000
(5) Fixed Assets	
Tangible Assets (Chart 'C' – W.N. 4)	8,80,000
(6) Other Current Assets	
(Chart 'C' – W.N. 4)	17,80,000

Working Notes :

(1a) Degree of Control = $\frac{4{,}800 \text{ Shares (Note 1b)}}{8{,}000 \text{ Shares}} = 3/5\text{th}; \text{Minority} = 2/5\text{th}$

(1b) 3 bonus shares were given for 5 shares held. H Ltd received bonus shares for 3,000 shares held = 3 / 5th x 3,000 = 1,800 shares. Post-bonus share holding of H Ltd = 3,000 + 1,800 = **4,800.**

(1c) When post bonus number of shares is 8, then pre-bonus shares is 5
When post bonus number of share is 1, then pre-bvonus shares is 5/8
When post bonus number of shares is 8,000, then pre-bonus shares is 5/8 x 8,000 = **5,000**
Share Capital before bonus issue = 5,000 x 100 = **₹ 5,00,000.**
Dividend @ 20% declared on 30.6.2008 = ₹ 1,00,000.

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances		Notes	Total (₹)	H Ltd.'s Share (3/5)	Minority Interest (2/5)
(a) Capital Profit					
1. Pre-acquisition Profit	2,00,000				
Less: Dividend from Pre-acquisition	1,00,000	(1c)	1,00,000		
2. Pre-acquisition General Reserve	5,00,000				
Less: Bonus Shares	3,00,000		2,00,000		
			3,00,000	1,80,000	1,20,000
(b) Post-acquisition Profit					
Profit as per Balance Sheet			3,00,000		
Less: Pre-acquisition Profit			1,00,000		
			2,00,000	1,20,000	80,000
(c) Post-acquisition Reserve					
Reserve as per Balance Sheet			2,00,000		
Less: Pre-acquisition Reserve			2,00,000		
			Nil	—	—
(d) Share Capital (After Bonus)			8.00,000		
Less : Minority Interest			3,20,000	—	3,20,000
			4,80,000		
Adjusted in Control Chart B			4,80,000		
	Minority Interest				5,20,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		5,00,000
Less: Capital Profit	1,80,000	
Less: Dividend from Pre-acquisition Profit	60,000	2,40,000
		2,60,000
Less: Face Value of Shares held		4,80,000
Capital Reserve (being negative)		(2,20,000)

(4) Control Chart C : Other Assets and Liabilities

Particulars	Fixed Assets	Debtors	Stock	Other Current Assets	Creditors	Other Current Liabilities
H Ltd.	5,00,000	1,00,000	2,00,000	5,00,000	—	2,00,000
S Ltd.	4,00,000	—	1,00,000	10,00,000	1,00,000	1,00,000
	9,00,000	1,00,000	3,00,000	15,00,000	1,00,000	3,00,000
Less: Unrealised Profit on Machinery	20,000					
	8,80,000					
Less: Unrealised Profit on Stock (25/125 x 1,00,000)			20,000			
			2,80,000			
Less: Mutual Indebtedness		1,00,000			1,00,000	
		—			—	

(5) Profit and Loss Account

Particulars	₹
H Ltd	4,00,000
Less: Pre-acquisition Dividend wrongly credited	60,000
	3,40,000
Less: Unrealised Profit on Sale of Machine	(20,000)
Less: Unrealised Profit on Stock	(20,000)
	3,00,000
S Ltd.'s Share of Profit (Chart B)	1,20,000
	4,20,000

(8) Proposed Dividend

When a dividend is proposed by the holding company, it will be deducted from the post-acquisition profit of the holding company (provided no proposed dividend is appearing in the Balance Sheet of the holding company) and will be shown in the Consolidated Balance Sheet as short-term provision.

Proposed dividend of the subsidiary will be deducted from the post-acquisition profit of the subsidiary company (provided no proposed dividend is appearing in the Balance Sheet of the subsidiary company).

Upto 31st March, 2015, as per the requirement of pre-revised Schedule VI, all companies (read holding companies) was recognising its share of proposed dividend of the subsidiary as income of the year in which it was proposed and accordingly they were crediting to the share of proposed dividend to the Profit and Loss Account.

The Schedule III applicable from 1st April, 2015 ***does not*** have this requirement. Accountants are divided in their opinion of the accounting treatment of the proposed dividend of the subsidiary. As the Schedule III is silent in this respect, the provision of AS–9 : "Revenue Recognition" becomes very relevant. AS–9 states that the dividend from investment in shares should be recognised as income only when the owner's ***right to receive payment*** is established. Logically, proposed dividend cannot be recognised as income until it is passed in the annual general meeting of the subsidiary. Therefore, the holding companies' share of proposed dividend of subsidiary should be shown in the Schedule III under "***Short-term Provisions***".

Example

H. Ltd is holding 80% equity shares of S. Ltd. S. Ltd proposed ₹ 1,00,000 as dividend at the time of finalising the accounts for the year ended on 31st March, 2016. Out of ₹ 1,00,000 proposed dividend, the holding company's share is ₹ 80,000 and minority shareholder's share is ₹ 20,000.

At the time of consolidation of the Balance Sheet for the year 2015-16, holding company's share of ₹ 80,000 will be shown under 'Short-term Provision'. However, minority's share of ₹ 20,000 could be added with the 'Minority Interest'.

Alternatively, minority shareholders' portion of proposed dividend could be shown separately under 'Short-term Provisions'. The alternative treatment is much more logical as these amount is to be paid to the minority shareholders immediately after the approval of proposed dividend in the Annual General Meeting. As these dividend will not remain in the Balance Sheet of the subsidiary company as 'Reserve and Surplus' it should not be added with the minority interest.

Points to Remember : ***Like proposed dividend, corporate dividend tax is also to be shown under 'Short-term Provisions'.***

Real Life Focus
Kiroloskar Brothers Limited

Dividend on Investment in Subsidiary Companies

Till the year end March 31, 2011 the company in accordance with the pre-revised schedule VI requirement, was recognising dividend declared by the subsidiary companies after reporting date in the current year's financial statement of profit and loss if such dividend pertained to the period ending on or before the reporting date. The revised schedule VI applicable for financial year commencing from April 1, 2015 does not contain this requirement. Hence, to comply with AS–9 Revenue Recognition, the company has changed its accounting policy for recognition of dividend from subsidiary companies. In accordance with the revised policy the company recognises dividend as income only when the right to receive the same is established by the reporting date. If the company had accrued dividend from subsidiary companies as per pre-revised schedule VI, its other income and other current assets for the current year would have been more by ₹ 9,934,500. ***[Source : Annual Report 2011-12]***

Illustration 11

Bengal Ltd. acquired 12,000 shares of Barakar Ltd. of the full value of ₹ 10 each at a price of ₹ 1,70,000 on 1.4.2015. The Balance Sheets of the two companies as at 31.3.2016 were as follows :

Balance Sheets of Bengal Ltd. and Barakar Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)	Amount ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		10,00,000	2,00,000
(b) Reserves and Surplus : General Reserve (1.4.2015)		4,20,000	1,00,000
Profit and Loss Account (1.4.2015)		90,000	40,000
Profit for the year		1,70,000	45,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sudry Creditors		2,40,000	92,000
Bills Payable		80,000	60,000
TOTAL		20,00,000	5,37,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Land and Building		4,00,000	1,00,000
Plant and Machinery		5,00,000	1,00,000

(ii) Intangible Assets — Goodwill		3,00,000	70,000
(b) Non-current investments		2,00,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories — Stock		2,00,000	40,500
(c) Trade Receivables — Debtors		3,00,000	1,34,500
Bills Receivables		20,000	30,000
(d) Cash and Cash Equivalents — Cash and Bank		80,000	62,000
TOTAL		20,00,000	5,37,000

Additional information :

(1) Stock in the hands of Barakar Ltd. includes goods purchased from Bengal Ltd. at ₹ 20,000 which includes profit charged by the latter company at 25% on cost.

(2) Both the companies have proposed 10% dividend for 2015–16.

(3) Out of the Debtors and Bills receivable of Bengal Ltd. ₹ 50,000 and ₹ 16,000 respectively represented due from Barakar Ltd.

Prepare a Consolidated Balance Sheet of Bengal Ltd. and its subsidiary Barakar Ltd. as at 31.3.2016.

Solution

Consolidated Balance Sheet of Bengal Ltd. and its Subsidiary Barakar Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus	(2)	6,25,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	1,46,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	4,06,000
(c) Other Current Liabilities		—
(d) Short-term Provisions	(5)	1,20,000
TOTAL		22,97,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	11,00,000
(ii) Intangible Assets	(6)	3,70,000
(2) Current Assets :		
(a) Current Investments	(7)	30,000
(b) Inventories	(8)	2,36,500
(c) Trade Receivables	(9)	4,18,500
(d) Cash and Cash Equivalents	(10)	1,42,000
TOTAL		22,97,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000

(6) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (Chart 'C' – W.N. 4)	5,00,000
Plant and Machinery (Chart 'C' – W.N. 4)	6,00,000
	11,00,000

(2) Reserve and Surplus			*Intangible Assets :*	
Capital Reserve (Chart 'B' – W.N. 3)		34,000	Goodwill (Chart 'C')	3,70,000
General Reserve		4,20,000	**(7) Current Investments** (₹ 2,00,000 – ₹ 1,70,000)	30,000
Profit and Loss Account (W.N. 5)		1,71,000		
		6,25,000		
			(8) Inventories	
(3) Minority Interest			Stock (Chart 'C' – W.N. 4)	2,36,500
(Chart 'A' – W.N. 2)		1,46,000	**(9) Trade Receivables**	
(4) Trade Payables			Debtors (Chart 'C' – W.N. 4)	3,84,500
Sundry Creditors (Chart 'C' – W.N. 4)		2,82,000	Bills Receivable (Chart 'C' – W.N. 4)	34,000
Bills Payable		1,24,000		4,18,500
		4,06,000	**(10) Cash and Cash Equivalents**	
(5) Short-term Provisions			Cash at Bank	1,42,000
Proposed Dividend				
Bengal Ltd	1,00,000			
Share of Barakar Ltd	12,000	1,12,000		
Minority Shareholders' Share		8,000		
		1,20,000		

Working Notes :

(1) Degree of Control = $\frac{12{,}000 \text{ Shares}}{20{,}000 \text{ Shares}}$ = 3/5th; Minority = 2/5th

(2) Control Chart A : From the Balance Sheet of Barakar Ltd.

Proprietary Balances	Notes	Total (₹)	Bengal Ltd.'s Share (3/5)	Minority Interest (2/5)
(a) Capital Profit				
1. Pre-acquisition Profit		40,000		
2. Pre-acquisition General Reserve		1,00,000		
		1,40,000	84,000	56,000
(b) Post-acquisition Profit				
Profit for the year		45,000		
Less: Proposed Dividend 10%		20,000	12,000	
		25,000	15,000	10,000
(c) Share Capital		2,00,000		
Less : Minority Interest (2/5)		80,000		80,000
		1,20,000		
Adjusted in Control Chart B		1,20,000		
Minority Interest				1,46,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		1,70,000
Less: Capital Profit	84,000	
Less: Face Value of Shares held	1,20,000	2,04,000
Capital Reserve (being negative)		(34,000)

(4) Control Chart C : Other Assets and Liabilities

Particulars	Goodwill	Land and Building	Plant and Machinery	Stock	Debtors	Bills Receivable	Sundry Creditors	Bills Payable
Bengal Ltd.	3,00,000	4,00,000	5,00,000	2,00,000	3,00,000	20,000	2,40,000	80,000
Barakar Ltd.	70,000	1,00,000	1,00,000	40,500	1,34,500	30,000	92,000	60,000

				2,40,500	4,34,500	50,000	3,32,000	1,40,000
Less: Unrealised Profit (6)	—	—	—	4,000	—	—	—	—
Less: Mutual Indebtedness	—	—	—	—	50,000	—	50,000	—
Less: Mutual Acceptances	—	—	—	—	—	16,000	—	16,000
	3,70,000	5,00,000	6,00,000	2,36,500	3,84,500	34,000	2,82,000	1,24,000

(5) Profit and Loss Account

	₹
Bengal Ltd.	
On 1.4.2015	90,000
Profit for 2015-16	1,70,000
	2,60,000
Less: 10% Proposed Dividend	1,00,000
	1,60,000
Add: Share from Barakar Ltd.	15,000
	1,75,000
Less: Unrealised Profit (Note 6)	4,000
	1,71,000

(6) Unrealised Profit on Unsold Stock

Let, cost = 100
Profit 25% = 25
Selling Price = 125

When selling price is 125 then profit is 25
When selling price is 1 then profit is 25 / 125
When selling price is 20,000 then price is 25/125 x 20,000 = 4,000.

Illustration 12

The summarised Balance Sheets of Vipul Ltd. and its subsidiary Vedika Ltd. as at 31st March, 2016 are as follows :

Balance Sheets of Vipul Ltd. and Vedika Ltd. as at 31st March, 2016

Particulars	Note No.	Vipul Ltd. (₹)	Vedika Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	6,00,000	5,00,000
(b) Reserves and Surplus : General Reserve (1.4.2015)		1,60,000	80,000
Profit and Loss Account		1,30,000	1,20,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables : Creditors		2,30,000	2,85,000
Bills Payable		20,000	25,000
(c) Short-term Provisions — Proposed Dividend		60,000	40,000
TOTAL		12,00,000	10,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		3,50,000	2,50,000
(ii) Intangible Assets — Goodwill		—	20,000
(b) Non-current Investments		3,60,000	90,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		2,20,000	3,60,000
(c) Trade Receivables : Debtors		2,10,000	2,50,000
Receivables		40,000	35,000
(d) Cash and Cash Equivalents — Cash		20,000	45,000
TOTAL		12,00,000	10,50,000

Vipul Ltd. purchased interest in Vedika Ltd. by acquiring its 3/4th equity share capital at a premium of 20% on 1st April, 2015.

Prepare a consolidated Balance Sheet in the books of Vipul Ltd. as on 31st March, 2016.

The following further information is to be taken into account :

(i) Profit and Loss Account of Vedika Ltd. includes an amount of ₹ 20,000 brought forward from the year 2014-15.

(ii) Creditors of Vipul Ltd. include an amount of ₹ 12,000 for purchases from Vedika Ltd. which are still unsold. Vedika Ltd. sells goods at 20% above cost.

(iii) Vedika Ltd. remitted a cheque for ₹ 10,000 on 31st March, 2016 which was received by Vipul Ltd. in the month of April 2016.

(iv) The directors of Vipul Ltd. and Vedika Ltd. have proposed a dividend of 10% on equity share capital for the year 2015-16.

Solution

Consolidated Balance Sheet of Vipul Ltd. and its Subsidiary Vedika Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	7,00,000
(b) Reserves and Surplus	(2)	3,63,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	1,50,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	5,48,000
(c) Other Current Liabilities		—
(d) Short-term Provisions	(5)	1,00,000
TOTAL		18,61,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	6,00,000
(ii) Intangible Assets	(6)	5,000
(b) Non-current Investments	(7)	90,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(8)	5,78,000
(c) Trade Receivables	(9)	5,13,000
(d) Cash and Cash Equivalents	(10)	75,000
TOTAL		18,61,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
... Equity Shares of ... each	?
... Preference Shares of ₹ ... each	?
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
10,000, 6% Preference Shares of ₹ 10 each fully paid	1,00,000
	7,00,000

(5) Short-term Provisions

Particulars	₹
Proposed Dividend :	
Vipul Ltd.	60,000
3/4 Share of Vedika Ltd	30,000
	90,000
Minority Shareholder's Share	10,000
	1,00,000

(2) Reserve and Surplus		**(6) Fixed Assets**	
General Reserve	1,60,000	Tangible Assets	6,00,000
Profit and Loss Account	2,03,000	Intangible Assets :	
	3,63,000	Goodwill (Chart 'C' – W.N. 4)	5,000
(3) Minority Interest		**(7) Non-Current Investments**	90,000
(Chart 'A' – W.N. 2)	1,50,000	**(8) Inventories** (Chart 'C' – W.N. 4)	5,78,000
		(9) Trade Receivables	
(4) Trade Payables		Sundry Debtors (Chart 'C' – W.N. 4)	4,38,000
Creditors (Chart 'C' – W.N. 4)	5,03,000	Bills Receivable (Chart 'C' – W.N. 4)	75,000
Bills Payable (Chart 'C' – W.N. 4)	45,000		5,13,000
	5,48,000	**(10) Cash and Cash Equivalents**	
		Cash (₹ 20,000 + 45,000 + 10,000)	75,000

Working Notes :

(1) Degree of Control = 3/4th; Minority = 1/4th

(2) Control Chart A : From the Balance Sheet of Vedika Ltd.

Proprietary Balances	Notes	Total (₹)	Vipul Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
1. Pre-acquisition Profit		20,000		
2. Pre-acquisition General Reserve		80,000		
		1,00,000	75,000	25,000
(b) Post-acquisition Profit				
Profit as per Balance Sheet		1,20,000		
Less: Pre-acquisition Profit		20,000		
		1,00,000	75,000	25,000
(c) Post-acquisition Reserve				
General Reserve as per Balance Sheet		80,000		
Less: Pre-acquisition Reserve		80,000		
		Nil		
(d) Share Capital		4,00,000		
Less : Minority Interest		1,00,000		1,00,000
		3,00,000		
Adjusted in Control Chart B		3,00,000		
Minority Interest				1,50,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		3,60,000
Less: Capital Profit (as per Control Chart A)		75,000
		2,85,000
Less: Face Value of Shares held		3,00,000
Capital Reserve (being negative)		(15,000)

(4) Control Chart C : Other Assets and Liabilities

Particulars	Goodwill	Fixed Assets	Investments	Stock	Debtors	Creditors	Bills Receivable
Vipul Ltd.	Nil	3,50,000	—	2,20,000	2,10,000	2,30,000	40,000
Vedika Ltd.	20,000	2,50,000	90,000	3,60,000	2,50,000	2,85,000	35,000
Less: Capital Reserve	15,000	—	—	—	—	—	—
	5,000	6,00,000	90,000	5,80,000	4,60,000	5,15,000	75,000
Less: Unrealised Profit on Stock				2,000			
				5,78,000			
Less: Mutual Indebtedness					12,000	12,000	
					4,48,000	5,03,000	
Less: Cash in Transit					10,000		
					4,38,000		

(5) Profit and Loss Account	₹	(6) Bank Balance	₹
Vipul Ltd.'s Profit Balance	1,30,000	Vipul Ltd	20,000
Share from Vedika Ltd.	75,000	Vedika Ltd	45,000
	2,05,000		65,000
L:ess: Untrealised Profit on Stock (20/120 x 12,000)	2,000	Add: Cash in Transit	10,000
	2,03,000		75,000

GENERAL ILLUSTRATIONS

Illustration 13

The following are the Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015 :

Balance Sheets of H Ltd. andS Ltd. as at 31st March, 2016

Particulars		Note No.	Amount (₹)	Amount ₹
(1)		(2)	(3)	(4)
I. EQUITY AND LIABILITIES				
(1) Shareholders' Funds :				
(a) Share Capital — Equity Share of ₹ 10 each			50,000	40,000
(b) Reserves and Surplus :	General Reserve		12,000	4,000
	Profit and Loss Account		10,000	6,000
(2) Share Application Money Pending Allotment :				
(3) Non-current Liabilities :				
(4) Current Liabilities :				
(a) Short-term Borrowings				
(b) Trade Payables :	External Creditors		11,000	5,000
	Amount Due to H Ltd.		—	2,900
TOTAL			83,000	57,900
II. ASSETS				
(1) Non-current Assets :				
(a) Fixed Assets				
(i) Tangible Assets — Land and Building			20,000	30,000
(b) Non-current Investments — 3,000 Equity Shares in S Ltd.			32,000	—
(2) Current Assets :				
(a) Current Investments			8,900	12,000
(b) Inventories :	Stock		4,000	9,000
	Goods-in-Transit		600	—
(c) Trade Receivables :	Debtors (External)		9,000	5,000
	Amount Due from S Ltd.		3,000	—
(d) Cash and Cash Equivalents — Cash at Bank			5,500	1,900
TOTAL			83,000	57,900

The credit balance of Profit and Loss Account of S Ltd. at the date H Ltd. bought its shares was ₹ 2,000 and the general reserve stood at nil.

On 31st December, 2015 there were goods-in-transit from H Ltd. to S Ltd. ₹ 600 and cash-in-transit ₹ 100 from S Ltd. to H Ltd. These had been entered only in the books of sending companies.

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary as at 31st December, 2015.

Solution

Before attempting this question, students are advised to re-read Rule 7 (Page 9.18)

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	50,000
(b) Reserves and Surplus	(2)	28,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	12,500
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings	(4)	16,000
TOTAL		1,06,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	50,000
(ii) Intangible Assets	(5)	500
(2) Current Assets :		
(a) Current Investments	(6)	20,900
(b) Inventories	(7)	13,600
(c) Trade Receivables	(8)	14,000
(d) Cash and Cash Equivalents	(9)	7,500
TOTAL		1,06,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
5,000 Equity Shares of ₹ 10 each fully paid	50,000

(2) Reserve and Surplus

Particulars	₹
General Reserve (Chart 'C' – W.N. 3)	15,000
Profit and Loss Account (Chart 'C' – W.N. 3)	13,000
	28,000

(3) Minority Interest

Particulars	₹
(Chart 'A')	12,500

(4) Trade Payables

Particulars	₹
Creditors (Chart 'C' – W.N. 4)	16,000

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (Chart 'C' – W.N. 4)	50,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	500

(6) Current Investments

Particulars	₹
(Chart 'C' – W.N. 4)	20,900

(7) Inventories

Particulars	₹
Stock in Hand (Chart 'C' – W.N. 4)	13,000
Stock-in-Transit (Chart 'C' – W.N. 5)	600
	13,600

(8) Trade Receivables

Particulars	₹
Debtors (Chart 'C' – W.N. 4)	14,000

(9) Cash and Cash Equivalents

Particulars	₹
Cash at Bank	7,400
Cash-in-Transit	100
	7,500

Working Notes :

(1) Degree of Control $\frac{3{,}000 \text{ Shares}}{4{,}000 \text{ Shares}}$ = 3/4th ; Minority = 1/4th

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
Pre-acquisition Profit		2,000	1,500	500
		2,000		
(b) Post-acquisition Profit				
Profit as per Balance Sheet		6,000		
Less: Pre-acquisition Profit (a)		2,000		
		4,000	3,000	1,000
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		4,000		
Less: Pre-acquisition General Reserve		Nil		
		4,000	3,000	1,000
(d) Share Capital		40,000		
Less : Minority Interest (1/4)		10,000		10,000
		30,000		
Adjusted in Control Chart B		30,000		
Minority Interest				12,500

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹
Cost of Investments	32,000
Less: Capital Profit (as per Control Chart A)	1,500
	30,500
Less: Face Value of Shares held	30,000
Goodwill	500

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Building	Debtors	Investments	Bank	Creditors	Stock	G. Reserve	P & L A/c
H Ltd.	20,000	9,000	8,900	5,500	11,000	4,000	12,000	10,000
S Ltd.	30,000	5,000	12,000	1,900	5,000	9,000	* 3,000	* 3,000
	50,000	14,000	20,900	7,400	16,000	13,000	15,000	13,000

* From Control Chart A — H Ltd.'s share.

(5) When goods were sent by H Ltd. to S Ltd., H Ltd. debited Goods-in-transit Account, that is why Goods-in-transit Account appearing in the Balance Sheet. After taking Cash-in-transit into account the final position in the books of H Ltd. will be as follows :

Dr. S Ltd. Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d	3,000		By Cash-in-transit A/c	100
				By Balance c/d	2,900
		3,000			3,000
	To Balance b/d	2,900			

Dr. Goods-in-Transit Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d	600		By Balance c/d	600
	To Balance b/d	600			

Dr. **Cash-in-Transit Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To S Ltd. A/c	100		By Balance c/d	100
	To Balance b/d	100			

At the time of consolidation, S Ltd. Account balance of ₹ 2,900 will be adjusted against H Ltd. Account balance of ₹ 2,900. Goods-in-transit of ₹ 600 and Cash-in-transit of ₹ 100 will appear in the Consolidated Balance Sheet.

Illustration 14

The summarised Balance Sheets of P Ltd. and S Ltd. on 31st December, 2015 were as follows :

Balance Sheets of P Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	P Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		3,00,000	1,00,000
(b) Reserves and Surplus : Capital Reserve		—	55,000
General Reserve		30,000	5,000
Profit and Loss Account		38,200	18,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings — Loan from S Ltd.		2,100	—
(b) Trade Payables : Bills Payable (including ₹ 500 to P Ltd.)		—	1,700
Sundry Creditors		17,900	7,000
TOTAL		3,88,200	1,86,700
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		1,50,000	1,44,700
(b) Non-current Investments — Equity Shares in S Ltd.		1,70,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories — Stock		40,000	20,000
(c) Trade Receivables — Bills Receivable (including ₹ 200 from S Ltd.)		1,200	—
(d) Cash and Cash Equivalents — Cash at Bank		27,000	20,000
(e) Short-term loans and advances — Loan to P Ltd.		—	2,000
TOTAL		3,88,200	1,86,700

There is a contingent liability of ₹ 1,000 for bills discounted given by way of a note to Balance Sheet of P Ltd.
P Ltd. acquired 8,000 shares of ₹ 10 each in S Ltd. on 31st December, 2015.
You are given the following additional information :

(i) S Ltd. made a bonus issue on 31st December, 2015 of one share for every two shares held, reducing capital reserve by an equivalent amount, but the transaction is not shown in the Balance Sheet.

(ii) Interest receivable amounting to ₹ 100 in respect of loan due by P Ltd. has not been credited in the accounts of S Ltd.

(iii) The directors decided that the land and building of S Ltd. were over- valued and should be written-down by ₹ 5,000.

Prepare a Consolidated Balance Sheet of the two companies on 31st December, 2015, giving all workings.

Solution

Consolidated Balance Sheet of P Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,00,000
(b) Reserves and Surplus	(2)	68,200
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	34,620
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	26,400
TOTAL		4,29,220
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,89,700
(ii) Intangible Assets	(5)	31,520
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	60,000
(c) Trade Receivables	(7)	1,000
(d) Cash and Cash Equivalents	(8)	47,000
TOTAL		4,29,220

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
30,000 Equity Shares of ₹ 10 each fully paid	3,00,000

(2) Reserve and Surplus

General Reserve (Chart 'C' – W.N. 3)	30,000
Profit and Loss Account (Chart 'C' – W.N. 3)	38,200
	68,200

(3) Minority Interest

(Chart 'B')	34,620

(4) Trade Payables

Creditors (Chart 'C' – W.N. 4)	24,900
Bills Payable (Chart 'C' – W.N. 4)	1,500
	26,400

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (Chart 'C' – W.N. 4)	2,89,700
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	31,520

(6) Inventories

Stock (Chart 'C' – W.N. 4)	60,000

(7) Trade Receivables

Bills Receivable (Chart 'C' – W.N. 4)	1,000

(8) Cash and Cash Equivalents

Cash at Bank	47,000

Tutorial Note : ***When the date of Balance Sheet and the date of acquisition are the same, all reserves and surplus appearing in the Balance Sheet will be treated as capital profit (i.e., pre- acquisition profit).***

Working Notes :

(1) Degree of Control = $\frac{8,000 \text{ Shares}}{10,000 \text{ Shares}}$ = 4/5th; Minority = 1/5th

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances		Notes	Total (₹)	P Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit					
1. Pre-acquisition Profit		5	18,100		
2. Pre-acquisition General Reserve			5,000		
3. Capital Reserve	55,000				
Less: Bonus Shares	50,000		5,000		
4. Revaluation Loss			(5,000)		
			23,100	18,480	4,620
(b) Post-acquisition Profit					
Profit as per Balance Sheet			18,000		
Add: Accrued Interest			100		
			18,100		
Less : Pre-acquisition Profit			18,100		
			Nil	Nil	Nil
(c) Post-acquisition General Reserve					
General Reserve as per Balance Sheet			5,000		
Less: Pre-acquisition General Reserve			5,000		
			Nil	Nil	Nil
(d) Share Capital			1,00,000		
Add: Bonus Shares			50,000		
			1,50,000		
Less : Minority Interest (1/5)			30,000		30,000
			1,20,000		
Adjusted in Control Chart B			1,20,000		
Minority Interest					34,620

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		1,70,000
Less: Capital Profit	18,480	
Less: Face Value of Shares held	1,20,000	1,38,480
Goodwill		31,520

(4) Control Chart C : Other Assets and Liabilities

Particulars	Sundry Creditors	Land and Building	Stock	Bills Receivable	Bills Payable	Cash at Bank
P Ltd.	17,900	1,50,000	40,000	1,200	—	27,000
S Ltd.	7,000	1,44,700	20,000	—	1,700	20,000
	24,900	2,94,700	—	—	—	—
Less: Revaluation Loss	—	5,000	—	—	—	—
Less: Mutual Acceptance	—	—	—	200	200	—
	24,900	2,89,700	60,000	1,000	1,500	47,000

(5) No entry has been passed in the books of S Ltd. in resepct of interest accrued ₹ 100. For recording it, the entry will be :

Loan to P Ltd. Account	Dr.	₹ 100	
To Profit and Loss Account			₹ 100

Therefore, the final balance of Loan to P Ltd. will be ₹ 2,100 and that of Profit and Loss Account will be ₹ 18,100.

(6) Loan from S Ltd. ₹ 2,100 and Loan to P Ltd. ₹ 2,100 will be eliminated.

Illustration 15

The following are the Balance Sheet of Hero Ltd and Sarin Ltd as at 31st December, 2015 :

Balance Sheets of Hero Ltd. and Sarin Ltd. as at 31st December, 2015

Particulars	Note No.	Hero Ltd. (₹)	Sarin Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		6,00,000	4,00,000
(b) Reserves and Surplus : Reserve		2,00,000	3,00,000
Profit and Loss Account		2,50,000	2,00,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		—	1,50,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		3,00,000	2,50,000
(c) Current Account with Hero Ltd.		—	50,000
TOTAL		13,50,000	13,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		4,80,000	6,00,000
(b) Non-current Investments :			
10% Debentures in Sarin Ltd. (Nominal value ₹ 80,000)		85,000	—
Equity Shares in Sarin Ltd. (24,000 shares)		3,50,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock in Trade		1,00,000	2,50,000
(c) Trade Receivables — Debtors		2,50,000	4,50,000
(d) Cash and cash equivalents — Cash		25,000	50,000
(e) Short-term loans and advances — Current Account with Sarin Ltd.		60,000	—
TOTAL		13,50,000	13,50,000

The following further information is furnished :

1. Hero Ltd acquired shares in Sarin Ltd on 1st January, 2015, when the Reserve and Profit and Loss Account was ₹ 4,00,000 and ₹ 2,00,000.
2. On 1st October, 2015, Sarin Ltd issued one share for every four shares held as bonus shares at a face value of ₹ 10 each. No entry is made in the books of Hero Ltd for the receipt of these bonus shares.
3. On 31.3.2015, Sarin Ltd declared a dividend out of its pre- acquisition profits of 25% on its then capital. Hero Ltd credited the dividend received to its Profit and Loss Account.
4. A remittance of ₹ 10,000 by Sarin Ltd to Hero Ltd has not yet been adjusted in the books of Hero Ltd.
5. Creditors of Sarin Ltd include ₹ 1,00,000 goods supplied by Hero Ltd on which Hero Ltd made a profit of ₹ 10,000. Half of the goods still in stock of Sarin Ltd on 31.12.2015.

Prepare Consolidated Balance Sheet on 31.12.2015.

Solution

Consolidated Balance Sheet of Hero Ltd. and its Subsidiary Sarin Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,00,000
(b) Reserves and Surplus	(2)	7,65,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	2,25,000
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(4)	70,000
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(5)	4,50,000
TOTAL		21,10,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	10,80,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	3,45,000
(c) Trade Receivables	(8)	6,00,000
(d) Cash and Cash Equivalents	(9)	85,000
TOTAL		21,10,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve (Chart 'C' – W.N. 3)	3,35,000
General Reserve (W.N. 6)	1,85,000
Profit and Loss Account (W.N. 5)	2,45,000
	7,65,000

(3) Minority Interest

Particulars	₹
(Chart 'A' – W.N. 2)	2,25,000

(4) Long-term Borrowings

Particulars	₹
10% Debentures	1,50,000
Less: Held within the Group	80,000
	70,000

(5) Trade Payables

Particulars	₹
Creditors (Chart 'C' – W.N. 4)	4,50,000

(6) Fixed Assets

Particulars	₹
Tangible Assets	
Land and Building (Chart 'C' – W.N. 4)	10,80,000

(7) Inventories

Particulars	₹
Stock-in-trade (Chart 'C' – W.N. 4)	3,45,000

(8) Trade Receivables

Particulars	₹
Debtors (Chart 'C' – W.N. 4)	6,00,000

(9) Cash and Cash Equivalents

Particulars	₹
Cash at Bank	75,000
Reimittance-in-Transit	10,000
	85,000

Working Notes :

(1) Degree of Control = $\frac{24,000 \text{ Shares} + 6,000 \text{ Shares (Bonus)}}{40,000 \text{ Shares}}$ = 3/4th; Minority = 1/4th.

(2) Control Chart A : From the Balance Sheet of Sarin Ltd.

Proprietary Balances		Notes	Total (₹)	Hero Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit					
1. Pre-acquisition Profit	2,00,000				
Less: Dividend paid (25% of ₹ 3,20,000)	80,000		1,20,000		
2. Pre-acquisition General Reserve	4,00,000				
Less: Bonus Shares (8,000 x ₹ 10)	80,000		3,20,000		
			4,40,000	3,30,000	1,10,000
(b) Post-acquisition Profit					
Profit as per Balance Sheet			2,00,000		
Less : Pre-acquisition profit			1,20,000		
			80,000	60,000	20,000
(c) Post-acquisition General Reserve					
General Reserve as per Balance Sheet			3,00,000		
Less: Pre-acquisition General Reserve			3,20,000		
			(20,000)	(15,000)	(5,000)
(d) Share Capital			4,00,000		
Less : Minority Interest			1,00,000		1,00,000
			3,00,000		
Adjusted in Control Chart B			3,00,000		
	Minority Interest				2,25,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments :		
In Equity Shares	3,50,000	
In Debentures	85,000	4,35,000
Less: Capital Profit (Chart A)		3,30,000
		1,05,000
Less: Dividend from Pre-acquisition Profit		60,000
		45,000
Less: Face Value of Shares held	3,00,000	
Less: Face Value of Debentures held	80,000	3,80,000
Capital Reserve (being negative)		(3,35,000)

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Building	Stock	Debtors	Cash	Creditors
Hero Ltd.	4,80,000	1,00,000	2,50,000	25,000	3,00,000
Sarin Ltd.	6,00,000	2,50,000	4,50,000	50,000	2,50,000
	10,80,000	3,50,000	7,00,000	75,000	5,50,000
Less: Mutual Indebtedness		—	1,00,000		1,00,000
Less : Unrealised Profit (Note 7)		5,000	—		—
		3,45,000	6,00,000		4,50,000

(5) Profit and Loss Account (Consolidated)	₹	**(6) General Reserve**	₹
Hero Ltd.	2,50,000	Hero Ltd.	2,00,000
Share from Sarin Ltd (Chart A)	60,000	Less: Share from Sarin Ltd (Chart A)	(15,000)
	3,10,000		1,85,000
Less: Pre-acquisition Profit wrongly credited to P/L A/c	60,000	**(7)** Half of the goods still in stock. Therefore unrealised profit on stock will be = 1/2 of ₹ 10,000 = ₹ 5,000. As per AS—21 entire unrealised profit on stock is to be eliminated.	
	2,50,000		
Less: Unrealised Profit on Stock (Note 7)	5,000		
	2,45,000		

Illustration 16

Following are the Balance Sheet of A Ltd and B Ltd as on March 31, 2016 :

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2016

Particulars	Note No.	A Ltd. (₹)	B Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		5,00,000	1,00,000
(b) Reserves and Surplus : General Reserve		2,00,000	60,000
Profit and Loss Account		1,20,000	1,40,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables :			
Sundry Creditors		80,000	60,000
Bills Payable		50,000	20,000
TOTAL		9,50,000	3,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
Building		2,00,000	1,00,000
Plant and Machinery		2,30,000	1,00,000
(b) Non-current Investments — 8,000 Equity Shares in B Ltd.		80,000	—
Others		30,000	10,000
(2) Current Assets :			
(a) Inventories — Stock		1,40,000	40,000
(b) Trade Receivables — Debtors		1,60,000	40,000
(c) Cash and Cash Equivalents — Bank		1,10,000	90,000
TOTAL		9,50,000	3,80,000

Additional information :

(i) A Ltd acquired 8,000 equity shares in B Ltd on 1.4.2014. On that date, B Ltd had ₹ 40,000 in Profit and Loss Account and ₹ 40,000 in General Reserve.

(ii) B Ltd declared on 1.7.2014 10% dividend for 2013-14 and 15% dividend on 1.6.2015 for 2014-15. A Ltd credited its share of both the dividends to Investment in B Ltd Account.

(iii) Further on 1.8.2015 B Ltd declared bonus dividend in the ratio of one for four held out of balance in General Reserve on 1.4.2014. B Ltd has not yet given effect to the bonus dividend in its accounts.

(iv) On 1.4.2015 B Ltd purchased plant and machinery for ₹ 60,000 from A Ltd which yielded a profit of 20% on selling price to A Ltd. B Ltd charges 10% depreciation on its plant and machinery.

(v) The entire bills payable of B Ltd represent bills accepted in favour of A Ltd.

(vi) Liability for expenses not given effect in the books of A Ltd amounts to ₹ 25,000.

Prepare Consolidated Balance Sheet in the books of A Ltd on 31.3.2016.

Solution

Consolidated Balance Sheet of A Ltd. and its Subsidiary P Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	5,00,000
(b) Reserves and Surplus	(2)	4,43,960
(c) Money Received against Share Warrants		—
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	60,240
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	2,10,000
(c) Other Current Liabilities	(5)	25,000
TOTAL		12,39,200
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	6,19,200
(b) Non-current Investments	(7)	40,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(8)	1,80,000
(c) Trade Receivables	(9)	2,00,000
(d) Cash and Cash Equivalents	(10)	2,00,000
TOTAL		12,39,200

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital : 50,000 Equity Shares of ₹ 10 each fully paid	5,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve (Chart 'B' – W.N. 3)	44,000
General Reserve (W.N. 6)	2,16,000
Profit and Loss Account (W.N. 5)	1,83,960
	4,43,960

(3) Minority Interest

Particulars	₹
(Chart 'A' – W.N. 2)	60,240

(4) Trade Payables

Particulars	₹
Sundry Creditors (W.N. 4)	1,40,000
Bills Payable (Chart 'C' – W.N. 4)	70,000
	2,10,000

(6) Other Current Liabilities

Particulars	₹
Liability for Expenses	25,000

(6) Fixed Assets

Particulars	₹
Tangible Assets	
Building (Chart 'C' – W.N. 4)	3,00,000
Plant and Machinery (Chart 'C' – W.N. 4)	3,19,200
	6,19,200

(7) Non-Current Investments

Particulars	₹
	40,000

(8) Inventories

Particulars	₹
Stock	1,80,000

(9) Trade Receivables

Particulars	₹
Debtors	2,00,000

(10) Cash and Cash Equivalents

Particulars	₹
Cash at Bank	2,00,000

Working Notes :

(1) Degree of Control = $\frac{8{,}000 \text{ Shares}}{10{,}000 \text{ Shares}}$ = 4/5th; Minority = 1/5th.

(2) Control Chart A : From the Balance Sheet of B Ltd.

Proprietary Balances		Notes	Total (₹)	A Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit					
1. Pre-acquisition Profit	40,000				
Less: Dividend paid for 2013-14 @ 10%	10,000		30,000		
2. Pre-acquisition General Reserve	40,000				
Less: Bonus Shares	25,000		15,000		
			45,000	36,000	9,000
(b) Post-acquisition Profit					
As per Balance Sheet			1,40,000		
Less: Pre-acquisition Profit			30,000		
			1,10,000		
Add: Depreciation over charged on Plant purchased from A Ltd (₹ 12,000 x 10%)			1,200		
			1,11,200	88,960	22,240
(c) Post-acquisition General Reserve					
As per Balance Sheet			60,000		
Less: Bonus Shares (Effect of which has not been given in the books of accounts of B Ltd.)			25,000		
			35,000		
Less: Pre-acquisition General Reserve (shown above)			15,000		
			20,000	16,000	4,000
(d) Share Capital					
10,000 Equity Shares of ₹ 10 each			1,00,000		
Add : Bonus Shares			25,000		
			1,25,000		
Less: Minority Interest (1/5)			25,000		25,000
			1,00,000		
Adjusted in Control Chart B			1,00,000		
Minority Interest					60,240

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹
Cost of Investments	80,000
Add: Share of Post-acquisition Profit (2014-15) wrongly credited to Investment A/c (4/5 x 15% of ₹ 1,00,000)	12,000
	92,000
Less: Capital Profit (Chart A)	36,000
	56,000
Less: Face Value of Shares held	1,00,000
Capital Reserve (Being negative)	(44,000)

(4) Control Chart C : Other Assets and Liabilities

Particulars	Building	Plant and Machinery	Other Investments	Stock	Debtors	Bank	Sundry Creditors	Bills Payable
A Ltd.	2,00,000	2,30,000	30,000	1,40,000	1,60,000	1,10,000	80,000	50,000
B. Ltd.	1,00,000	1,00,000	10,000	40,000	40,000	90,000	60,000	20,000
	3,00,000	3,30,000	40,000	1,80,000	2,00,000	2,00,000	1,40,000	70,000
Less: Unrealised Profit		12,000						
		3,18,000						
Add : Depreciation over charged		1,200						
		3,19,200						

(5) Profit and Loss Account (Consolidated)	₹	(6) General Reserve	₹
Profit and Loss Account balance of A Ltd.	1,20,000	A Ltd	2,00,000
Add: Share of Post-acquisition Profit (2014-15) wrongly credited to the Investment A/c	12,000	Add: Share from B Ltd	16,000
			2,16,000
	1,32,000	**(7)** Though the entire bills payable of B Ltd represent bills accepted in favour of A Ltd but A Ltd has no bills receivable in its Balance Sheet. It means all bills receivables have already been discounted.	
Less: Unrealised Profit on sale of Plant	12,000		
	1,20,000		
Less: Amount of Expenses not yet adjusted	25,000		
	95,000		
Add: Share of Post-acquisition Profit from B Ltd.	88,960		
	1,83,960		

Acquisition of Shares during the Accounting Period

A holding company may acquire controlling shares of its subsidiary during the accounting period. In this case, current year's profit upto the date of acquisition should be treated as pre-acquisition profit (capital profit) and it should be taken into consideration for calculating goodwill / capital reserve.

For calculating current year's profit, it is better to redraft the current year's Profit and Loss Account after taking into the account the amount transferred to general reserve or otherwise appropriated. The profits are to be apportioned between pre- and post-acquisition period on the basis of time (assuming profit has been accrued evenly throughout the period).

Example

The following were the balances in the Balance Sheet of S Ltd.	1.1.2015	31.12.2015
General Reserve	₹ 18,000	₹ 30,000
Profit and Loss Account	₹ 14,000	₹ 60,000

Majority shares in S Ltd. were acquired by H Ltd. on 1st July, 2015. Find out the amount of pre-acquisition profit and post-acquisition profit.

Solution

For calculating profit of 2015, the Profit and Loss Account of 2015 can be redrafted as follows :

Dr. Profit and Loss Account of S Ltd. for the year ended 31st December, 2015 Cr.

Particulars	₹	Particulars	₹
To General Reserve (₹ 30,000 – ₹ 18,000)	12,000	By Balance from last year	14,000
To Balance c/d	60,000	By Profit during the year (Balancing figure)	58,000
	72,000		72,000

So, profit upto 30.6.2015, if accrued evenly amounted to ₹ 29,000 (1/2 of ₹ 58,000) and the profit on 30.6.2015 will be :

Profit on 1.1.2015	₹ 14,000
Proportionate profit upto 30.6.2015	₹ 29,000
	₹ 43,000

Entire accruation to General reserve may be taken as current profit, as the transfer was made on the date of account, i.e., 31.12.2015. So current profit will be ₹ 29,000 – ₹ 12,000 (transferred to General reserve) = ₹ 17,000.

Illustration 17

The Balance Sheets of H Ltd. and its subsidiary S Ltd. as at 31st March, 2016 were as under :

Balance Sheets of H Ltd. and S Ltd. as at 31st March, 2016

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	20,00,000	5,00,000
(b) Reserves and Surplus	(2)	12,00,000	5,50,000
(2) Share Application Money Pending Allotment :		—	—

(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Bills Payable		1,50,000	—
(b) Creditors		3,00,000	3,00,000
(c) Other Current Liabilities		2,00,000	—
TOTAL		38,50,000	13,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		6,00,000	—
Plant and Machinery		20,00,000	—
Furniture and Fitting		90,000	1,00,000
(b) Non-current Investments — 30,000 Equity Shares in S Ltd. (at Cost)		6,50,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		4,00,000	7,50,000
(c) Trade Receivables :			
Debtors		1,00,000	2,80,000
Bills Receivable		—	1,00,000
(d) Cash and Cash Equivalents — Cash at Bank		10,000	1,20,000
TOTAL		38,50,000	13,50,000

Notes to Accounts :

(1) Share Capital

Particulars	H Ltd. ₹	S Ltd. ₹
Issued, Subscribed and Paid-up Capital :		
Equity Share of ₹ 10 each fully paid	20,00,000	5,00,000
(2) Reserve and Surplus		
General Reserve (1.4.2015)	3,00,000	1,00,000
Profit and Loss Account :		
Balance on 1.4.2015	4,00,000	2,00,000
Profit for the year ended 31.3.2016	5,00,000	2,50,000
	12,00,000	5,50,000

All the 30,000 shares in S Ltd. were acquired by H Ltd. on 1st October, 2015. Bills receivable held by S Ltd. are all accepted by H Ltd. Included in Debtors of S Ltd. is a sum of ₹ 60,000 owing by H Ltd. in respect of goods supplied by S Ltd.

You are required to prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 2016. Give all your working notes clearly.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	20,00,000
(b) Reserves and Surplus	(2)	12,75,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	4,20,000
(4) Non-current Liabilities :		—

(5) Current Liabilities :		—
(a) Trade Payables	(4)	5,90,000
(b) Other Current Liabilities	(5)	2,00,000
TOTAL		44,85,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	27,90,000
(ii) Intangible Assets	(6)	95,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	11,50,000
(c) Trade Receivables	(8)	3,20,000
(d) Cash and Cash Equivalents	(9)	1,30,000
TOTAL		44,85,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
2,00,000 Equity Shares of ₹ 10 each fully paid	20,00,000
(2) Reserve and Surplus	
General Reserve (W.N. 6)	3,00,000
Profit and Loss Account (W.N. 5)	9,75,000
	12,75,000
(3) Minority Interest	
(Chart 'A' – W.N. 2)	4,20,000
(4) Trade Payables	
Sundry Creditors (Chart 'C' – W.N. 4)	5,40,000
Bills Payable (Chart 'C' – W.N. 4)	50,000
	5,90,000
(5) Other Current Liabilities	2,00,000

(6) Fixed Assets

Particulars	₹
Tangible Assets	
Land and Building	6,00,000
Plant and Machinery	20,00,000
Furniture and Fixtures (Chart 'C' – W.N. 4)	1,90,000
	27,90,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	95,000
(8) Inventories	
Stock (Chart 'C' – W.N. 4)	11,50,000
(9) Trade Receivables	
Sundry Debtors	3,20,000
(10) Cash and Cash Equivalents	
Cash at Bank (10,000 + 1,20,000)	1,30,000

Working Notes :

(1) Degree of Control = $\frac{30,000 \text{ Shares}}{50,000 \text{ Shares}}$ = 3/5th; Minority = 2/5th.

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (3/5)	Minority Interest (2/5)
(a) Capital Profit				
1. Pre-acquisition Profit	7	3,25,000		
2. Pre-acquisition General Reserve		1,00,000		
		4,25,000	2,55,000	1,70,000
(b) Post-acquisition Profit				
1/2 of the profit earned during 2015-16		1,25,000	75,000	50,000

(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		1,00,000		
Less: Pre-acquisition General Reserve		1,00,000	—	—
		Nil	Nil	Nil
(d) Share Capital		5,00,000		
Less : Minority Interest (2/5)		2,00,000		2,00,000
		3,00,000		
Adjusted in Control Chart B		3,00,000		
Minority Interest				4,20,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		6,50,000
Less: Capital Profit	2,55,000	
Less: Face Value of Shares held	3,00,000	5,55,000
Goodwill		95,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Building	Plant and Machinery	Furniture and Fixtures	Stock	Debtors	Bills Receivable	Bills Payable	Creditors
H. Ltd.	6,00,000	20,00,000	90,000	4,00,000	1,00,000	—	1,50,000	3,00,000
S. Ltd.	—	—	1,00,000	7,50,000	2,80,000	1,00,000	—	3,00,000
	—	—	—	—	3,80,000	1,00,000	1,50,000	6,00,000
Less: Mutual Indebtedness	—	—	—	—	60,000	—	—	60,000
Less : Mutual Acceptance	—	—	—	—	—	1,00,000	1,00,000	—
	6,00,000	20,00,000	1,90,000	11,50,000	3,20,000	Nil	50,000	5,40,000

(5) Profit and Loss Account (Consolidated)

	₹
H Ltd. (₹ 4,00,000 + ₹ 5,00,000)	9,00,000
Share of Post-acquisition Profit from S Ltd. (Chart A)	75,000
	9,75,000

(6) General Reserve

	₹
H Ltd.	3,00,000
Share from S Ltd.	Nil
	3,00,000

(7) Pre-acquisition profit = ₹ 2,00,000 (1.4.2015) + 1/2 of ₹ 2,50,000 (profit earned during the year 2015-16) = ₹ 2,00,000 + ₹ 1,25,000 = ₹ 3,25,000.

Illustration 18

The Balance Sheets of H Ltd. and its subsidiary S Ltd. as on 31.12.2015 were as follows :

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 1 each		10,000	6,000
(b) Reserves and Surplus :			
General Reserve		4,000	—
Profit and Loss Account		4,000	1,800
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		2,000	2,200
TOTAL		20,000	10,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		16,000	10,000
(b) Non-current Investments — 4,000 Equity Shares in S Ltd.		4,000	—
(2) Current Assets :		—	—
TOTAL		20,000	10,000

The shares were purchased by H Ltd. in S Ltd. on 30th June, 2015. On 1st January, 2015 the Profit and Loss Account of S Ltd. showed a loss of ₹ 3,000 which was written-off from profits earned during the year. Profits were earned uniformly over the year 2015.

Prepare a Consolidated Balance Sheet of H Ltd. and S Ltd. as on 31st December, 2015 giving the workings.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,000
(b) Reserves and Surplus	(2)	9,600
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	2,600
(4) Non-current Liabilities :		—
(5) Current Liabilities :		
(a) Trade Payables	(4)	4,200
TOTAL		26,400
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	26,000
(ii) Intangible Assets	(5)	400
(2) Current Assets :		—
TOTAL		26,400

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
10,000 Equity Shares of ₹ 1 each fully paid	10,000

(2) Reserve and Surplus

General Reserve (Chart 'C' – W.N. 4)	4,000
Profit and Loss Account (Chart 'C' – W.N. 4)	5,600
	9,600

(3) Minority Interest

(Chart 'A' – W.N. 3)	2,600

(4) Trade Payable

Particulars	₹
Sundry Creditors	4,200

(5) Fixed Assets

Tangible Assets :	
Land and Building	26,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	400

Working Notes :

(1) Degree of Control = $\frac{4,000 \text{ Shares}}{6,000 \text{ Shares}}$ = 2/3rd; Minority = 1/3rd.

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (2/3)	Minority Interest (1/3)
(a) Capital Profit				
Pre-acquisition Profit	5	(600)		
		(600)	(400)	(200)
(b) Post-acquisition Profit				
Profit as per Balance Sheet		1,800		
Add: Pre-acquisition Loss		600		
		2,400	1,600	800
(d) Share Capital		6,000		
Less : Minority Interest (1/3)		2,000		2,000
		4,000		
Adjusted in Control Chart B		4,000		
Minority Interest				2,600

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		4,000
Less: Capital Profit	(400)	
Less: Face Value of Shares held	4,000	3,600
Goodwill		400

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Building	Creditors	P & L A/c (Consold.)	General Reserve
H Ltd.	16,000	2,000	4,000	4,000
S Ltd.	10,000	2,200	*1,600	—
	26,000	4,200	5,600	4,000

* Share of post-acquisition Profit

Dr. (5) Profit and Loss Account of S Ltd. for the year ended 31st December, 2015 Cr.

To Balance from last year	3,000	By Profit during the year (Balancing figure)	4,800
To Balance c/d	1,800		
	4,800		4,800

Therefore, Profit upto 30.6.2015 amounted to ₹ 2,400 (1/2 of ₹ 4,800) and the Profit as on 30.6.2015 will be :

Profit on 1.1.2015	₹ (3,000)
Proportionate Profit upto 30.6.2015	₹ 2,400
	₹ (600)

Illustration 19

The following are the Balance Sheets of H Ltd. and its subsidiary S Ltd. as at 31st March, 2016 :

Balance Sheets of H Ltd. and S Ltd. as at 31st March, 2016

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		6,00,000	2,00,000
(b) Reserves and Surplus : General Reserve		3,40,000	80,000
Profit and Loss Account		1,00,000	60,000

(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Creditors		70,000	35,000
TOTAL		11,10,000	3,75,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Machinery		3,90,000	1,35,000
Furniture		80,000	40,000
(b) Non-current Investments — 80% Equity Shares in S ltd. at cost		3,40,000	—
(2) Current Assets :			
(a) Inventories — Stock		1,80,000	1,20,000
(b) Trade Receivables — Debtors		50,000	30,000
(c) Cash and Cash Equivalents — Cash at Bank		70,000	50,000
TOTAL		11,10,000	3,75,000

The following additional information is provided to you :

(i) Profit and Loss Account of S Ltd. stood at ₹ 30,000 on 1.4.2015, whereas General Reserve has remained unchanged since that date.

(ii) H Ltd. acquired 80% shares in S Ltd. on 1.10.2015 for ₹ 3,40,000 as mentioned above.

(iii) Included in Debtors of S Ltd. is a sum of ₹ 10,000 due from H Ltd. for goods sold at a profit of 25% on cost price. Till 31.3.2016, only one-half of the goods had been sold while the remaining goods were lying in the godown of H Ltd. as on that date.

You are required to prepare Consolidated Balance Sheet as at 31st March, 2016. Show all calculations clearly.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	6,00,000
(b) Reserves and Surplus	(2)	4,51,000
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	68,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		
(a) Trade Payables	(4)	95,000
TOTAL		12,14,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	6,45,000
(ii) Intangible Assets	(5)	80,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	2,99,000
(c) Trade Receivables	(7)	70,000
(d) Cash and Cash Equivalents	(8)	1,20,000
TOTAL		12,14,000

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
60,000 Equity Shares of ₹ 10 each fully paid	6,00,000
(2) Reserve and Surplus	
General Reserve (W.N. 7)	3,40,000
Profit and Loss Account (W.N. 6)	1,11,000
	4,51,000
(3) Minority Interest	
(Chart 'A' – W.N. 3)	68,000
(4) Trade Payables	
Sundry Creditors (Chart 'C' – W.N. 4)	95,000

(5) Fixed Assets

Particulars	₹
Tangible Assets	
Plant and Machinery (Chart 'C' – W.N. 4)	5,25,000
Furniture (Chart 'C' – W.N. 4)	1,20,000
	6,45,000
Intangible Assets :	
Goodwill (Chart 'B' – W.N. 3)	80,000
(6) Inventories	
Stock (Chart 'C' – W.N. 4)	2,99,000
(7) Trade Receivables	
Debtors	70,000
(8) Cash and Cash Equivalents	
Cash at Bank	1,20,000

Working Notes :

(1) Degree of Control = 80% or 4/5th; Minority = 1/5th.

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit				
1. Pre-acquisition Profit	5	45,000		
2. Pre-acquisition General Reserve		80,000		
		1,25,000	1,00,000	25,000
(b) Post-acquisition Profit				
Profit as per Balance Sheet		60,000		
Less: Pre-acquisition Profit		45,000		
		15,000	12,000	3,000
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		80,000		
Less: Pre-acquisition General Reserve		80,000	—	—
		Nil	Nil	Nil
(d) Share Capital		2,00,000		
Less : Minority Interest (20%)		40,000		40,000
		1,60,000		
Adjusted in Control Chart B		1,60,000		
Minority Interest				68,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		3,40,000
Less: Capital Profit	1,00,000	
Less: Face Value of Shares held	1,60,000	2,60,000
Goodwill		80,000

(4) Control Chart C : Other Assets and Liabilities

	Machinery	Furniture	Stock	Debtors	Bank	Creditors
H. Ltd.	3,90,000	80,000	1,80,000	50,000	70,000	70,000
S. Ltd.	1,35,000	40,000	1,20,000	30,000	50,000	35,000
	—	—	3,00,000	80,000	—	1,05,000
Less: Mutual Indebtedness	—	—	—	10,000	—	10,000
Less : Unrealised Profit (Note 8)	—	—	1,000	—	—	—
	5,25,000	1,20,000	2,99,000	70,000	1,20,000	95,000

Dr. (5) Profit and Loss Account of S Ltd. for the year ended 31st March, 2016 Cr.

To Balance c/d	60,000	By Balance from last year	30,000
		By Profit during the year (Balancing figure)	30,000
	60,000		60,000

Therefore, Profit upto 30.9.2015, if accrued evenly amounted to ₹ 15,000 (1/2 of ₹ 30,000) and Profit as on 30.9.2015 will be :

Profit on 1.4.2015	₹ 30,000
Proportionate Profit upto 30.9.2015	₹ 15,000
	₹ 45,000

(6) Profit and Loss Account (Consolidated)	₹	(7) General Reserve	₹
H Ltd.	1,00,000	H Ltd.	3,40,000
Share of Post-acquisition Profit from S Ltd. (Chart A)	12,000	Share from S Ltd.	Nil
	1,12,000		
Less: Unrealised Profit on Stock (Note 8)	1,000		
	1,11,000		3,40,000

(8) Calculation of Unrealised Profit on Unsold Stock

S Ltd. sold goods to H Ltd. for ₹ 10,000 at a profit of 25% on cost. S Ltd. made a profit of ₹ 2,000 (25 / 125 × ₹ 10,000). Half of the goods is unsold. So, unrealised profit = 1/2 of ₹ 2,000 = ₹ 1,000. **As per AS—21 entire unrealised profit on stock is to be eliminated**.

Illustration 20

Following are the Balance Sheets of P Ltd. and R Ltd. as at December 31, 2015 :

Balance Sheets of P Ltd. and R Ltd. as at 31st December, 2015

Particulars	Note No.	P Ltd. (₹)	R Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,50,000	1,00,000
(b) Reserves and Surplus : General Reserve		75,000	30,000
Profit and Loss Account		70,000	60,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(b) Trade Payables :			
Creditors		50,000	20,000
Bills Payable		5,000	2,000
TOTAL		4,50,000	2,12,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :— Plant and Machinery		2,00,000	1,20,000
(ii) Intangible Assets — Goodwill		20,000	10,000
(b) Non-current Investments — 6,000 Equity Shares in R Ltd.		85,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		80,000	30,000
(c) Trade Receivables — Debtors		60,000	50,000
(d) Cash and Cash Equivalents — Cash in Hand		5,000	2,000
TOTAL		4,50,000	2,12,000

Additional information :

(1) Shares in R Ltd. were acquired by P Ltd. on 1st July, 2015.

(2) R Ltd. had on 1.1.2015 ₹ 18,000 in General Reserve and ₹ 14,000 in Profit and Loss Account.

(3) Included in the creditors of R Ltd. is ₹ 12,000 for goods supplied by P Ltd.

(4) Included in the stock of R Ltd. are goods to the value of ₹ 6,000 which were supplied by P Ltd. at a profit of 25% on cost.

Prepare a Consolidated Balance Sheet as at 31.12.2015 showing necessary workings.

Solution

Consolidated Balance Sheet of P Ltd. and its Subsidiary R Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,50,000
(b) Reserves and Surplus	(2)	1,72,800
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	76,000
(4) Non-current Liabilities :		—
(5) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	65,000
TOTAL		5,63,800
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	3,20,000
(ii) Intangible Assets	(5)	30,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,08,800
(c) Trade Receivables	(7)	98,000
(d) Cash and Cash Equivalents	(8)	7,000
TOTAL		5,63,800

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
25,000 Equity Shares of ₹ 10 each fully paid	2,50,000

(2) Reserve and Surplus

Capital Reserve (Chart 'C' – W.N. 3)	11,600
General Reserve	82,200
Profit and Loss Account	79,000
	1,72,800

(3) Minority Interest

(Chart 'A' – W.N. 2)	76,000

(5) Fixed Assets

Particulars	₹
Tangible Assets	
Plant and Machinery	3,20,000
Intangible Assets :	
Goodwill	30,000

(6) Inventories

Stock (Chart 'C' – W.N. 4)	1,08,800

(7) Trade Receivables

Debtors	98,000

(10) Cash and Cash Equivalents

Cash in Hand (5,000 + 2,000)	7,000

(4) Trade Payables	
Creditors (Chart 'C' – W.N. 4)	58,000
Bills Payable (Chart 'C' – W.N. 4)	7,000
	65,000

Working Notes :

(1) Degree of Control = $\frac{6{,}000 \text{ Shares}}{10{,}000 \text{ Shares}}$ = 3/5th; Minority = 2/5th.

(2) Control Chart A : From the Balance Sheet of R Ltd.

Proprietary Balances	Notes	Total (₹)	P Ltd.'s Share (3/5)	Minority Interest (2/5)
(a) Capital Profit				
1. Pre-acquisition Profit	7	43,000		
2. Pre-acquisition General Reserve		18,000		
		61,000	36,600	24,400
(b) Post-acquisition Profit				
Profit as per Balance Sheet		60,000		
Less: Pre-acquisition Profit		43,000		
		17,000	10,200	6,800
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		30,000		
Less: Pre-acquisition General Reserve		18,000		
		12,000	7,200	4,800
(d) Share Capital		1,00,000		
Less : Minority Interest (2/5)		40,000		40,000
		60,000		
Adjusted in Control Chart B		60,000		
Minority Interest				76,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		85,000
Less: Capital Profit	36,600	
Less: Face Value of Shares held	60,000	96,600
Capital Reserve (being negative)		(11,600)

(4) Control Chart C : Other Assets and Liabilities

Particulars	Goodwill	Plant and machinery	Stock	Debtors	Cash	S. Creditors	B / P
P. Ltd.	20,000	2,00,000	80,000	60,000	5,000	50,000	5,000
R. Ltd.	10,000	1,20,000	30,000	50,000	2,000	20,000	2,000
	—	—	1,10,000	1,10,000	—	70,000	—
Less: Mutual Indebtedness	—	—	—	12,000	—	12,000	—
Less : Unrealised Profit on Stock (Note 8)	—	—	1,200	—	—	—	—
	30,000	3,20,000	1,08,800	98,000	7,000	58,000	7,000

(5) Profit and Loss Account (Consolidated)	₹
P Ltd.	70,000
Share of Post-acquisition Profit from R Ltd. (Chart A)	10,200
	80,200
Less: Unrealised Profit on Stock (Note 8)	1,200
	79,000

(6) General Reserve	₹
P Ltd.	75,000
Share from R Ltd.	7,200
	82,200

Dr. (7) Profit and Loss Account of R Ltd. for the year ended 31st December, 2015 Cr.

To General Reserve (₹ 30,000 – ₹ 18,000)	12,000	By Balance from last year	14,000
To Balance c/d	60,000	By Profit during the year (Balancing Figure)	58,000
	72,000		72,000

Therefore, profit upto 30.6.2015, if accrued evenly, amounted to ₹ 29,000 (1/2 of ₹ 58,000) and the profit as on 30.6.2015 will be:

Profit on 1.1.2015	₹ 14,000
Proportionate Profit upto 30.6.2015	₹ 29,000
	₹ 43,000

Entire accretion to General Reserve may be taken as current profit, as the transfer was made on the date of account, i.e., 31.12.2015. Therefore, current profit will be ₹ 29,000 – ₹ 12,000 (transferred to General Reserve) = ₹ 17,000 which is same as :

As per Balance Sheet	₹ 60,000
Profit and Loss Account	₹ 43,000
Post-acquisition Profit	₹ 17,000

(8) Unrealised Profit on Stock = 25/125 × ₹ 6,000 = ₹ 1,200. As per AS—21 entire unrealised profit on stock is to be eliminated.

Illustration 21

The following are the summarised Balance Sheets of H Ltd and its subsidiary S Ltd as at 31st December, 2015 :

Balance Sheets of H Ltd. and S Ltd. as at 31st March, 2016

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Shares of ₹ 100 each fully paid		20,00,000	7,50,000
(b) Reserves and Surplus : General Reserve		10,50,000	65,000
Profit and Loss Account		7,50,000	4,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sundry Creditors		2,00,000	2,97,250
(c) Other Current Liabilities		—	—
TOTAL		40,00,000	15,12,250
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Freehold Premises		11,00,000	4,45,000
Plant and Machinery		5,75,000	1,60,000
Furniture		3,05,000	90,000
(b) Non-current Investments — 5,000 Equity Shares in S Ltd.		9,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-trade		5,10,000	3,40,250
(c) Trade Receivables — Sundry Debtors		4,85,000	4,11,000
(d) Cash and Cash Equivalents — Cash in Hand		1,25,000	66,000
TOTAL		40,00,000	15,12,250

You are to prepare a Consolidated Balance Sheet as at 31.12.2015 showing necessary adjustments and taking into consideration the following information :

(a) H Ltd acquired shares of S Ltd on 1.4.2015.

(b) On 1.1.2015, S Ltd has ₹ 45,000 in General Reserve and ₹ 3,30,000 credit balance on Profit and Loss Account.

(c) Creditors of ₹ 2,00,000 in the books of H Ltd on 31.12. 2015 included a sum of ₹ 1,20,000 payable to S Ltd for credit purchases on which the later company made a profit of ₹ 30,000 in 2015.

(d) S Ltd declared and paid interim dividend of 20% per annum on 1.6.2015.

(e) Stock of ₹ 5,10,000 of H Ltd on 31.12.2015 included unsold goods purchased from S Ltd at a cost of ₹ 90,000.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	20,00,000
(b) Reserves and Surplus	(2)	18,12,083
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	4,05,000
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	3,77,250
TOTAL		45,94,333
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	26,75,000
(ii) Intangible Assets	(5)	1,24,583
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	8,27,750
(c) Trade Receivables	(7)	7,76,000
(d) Cash and Cash Equivalents	(8)	1,91,000
TOTAL		45,94,333

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 100 each fully paid	20,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve (W.N. 7)	10,63,333
Profit and Loss Account (W.N. 6)	7,48,750
	18,12,083

(3) Minority Interest

Particulars	₹
(Chart 'A' – W.N. 2)	4,05,000

(4) Trade Payables

Particulars	₹
Sundry Creditors	3,77,250

(5) Fixed Assets

Particulars	₹
Tangible Assets	
Freehold Premises (Chart 'C' – W.N. 4)	15,45,000
Plant and Machinery	7,35,000
Furniture	3,95,000
	26,75,000
Intangible Assets :	
Goodwill	1,24,583

(6) Inventories

Particulars	₹
Stock-in-Trade	8,27,750

(7) Trade Receivables

Particulars	₹
Sundry Debtors	7,76,000

(8) Cash and Cash Equivalents

Particulars	₹
Cash in Hand	1,91,000

Working Notes :

(1) Degree of Control = $\frac{5,000 \text{ Shares}}{7,500 \text{ Shares}}$ = 2/3rd; Minority = 1/3rd.

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (2/3)	Minority Interest (1/3)
(a) Capital Profit				
1. Pre-acquisition Profit	9	3,30,625		
2. Pre-acquisition General Reserve		45,000		
		3,75,625	2,50,417	1,25,208
(b) Post-acquisition Profit	10	69,375	46,250	23,125
(c) Post-acquisition General Reserve		20,000	13,333	6,667
(d) Share Capital		7,50,000		
Less : Minority Interest (1/3)		2,50,000		2,50,000
		5,00,000		
Adjusted in Control Chart B		5,00,000		
Minority Interest				4,05,000

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments (Note 4)		9,00,000
Less: Capital Profit	2,50,417	
Less: Pre-acquisition Interim Dividend (2/3rd of ₹ 37,500)	25,000	
Less: Face Value of Shares held	5,00,000	7,75,417
Goodwill (being positive)		1,24,583

(4) It is assumed that interim dividend received by A Ltd has been totally credited to Profit and Loss Account without adjusting anything against Investment Account.

(5) Control Chart C : Other Assets and Liabilities

Particulars	Freehold Premises	Plant and Machinery	Furniture	Stock-in-trade	Sundry Debtors	Cash	Sundry Creditors
H. Ltd.	11,00,000	5,75,000	3,05,000	5,10,000	4,85,000	1,25,000	2,00,000
S. Ltd.	4,45,000	1,60,000	90,000	3,40,250	4,11,000	66,000	2,97,250
	15,45,000	7,35,000	3,95,000	8,50,250	8,96,000	1,91,000	4,97,250
Less: Mutual Indebtedness				—	1,20,000		1,20,000
				—	7,76,000		3,77,250
Less : Unrealised Profit on stock (Note 8)				22,500			
				8,27,750			

(6) Profit and Loss Account (Consolidated)

	₹
H Ltd.	7,50,000
Less: Interim dividend for 3 months received out of Pre-acquisition Profit wrongly credited to P/L A/c	25,000
	7,25,000
Add: Share of Post-acquisition Profit (Chart A)	46,250
	7,71,250
Less: Unrealised Profit on Stock (Note 8)	22,500
	7,48,750

(7) General Reserve

	₹
H Ltd.	10,50,000
Share from S Ltd. (Chart A)	13,333
	10,63,333

(8) Unrealised Profit on Stock

₹ 30,000 / ₹ 1,20,000 x ₹ 90,000 = ₹ 22,500.

As per AS—21 entire unrealised profit on stock is to be eliminated.

(9) Profit and Loss Account of S Ltd for the year ended 31st December, 2015

	₹		₹
To Interim Dividend	62,500	By Balance b/d	3,30,000
To General Reserve	20,000	By Profit during the year (Balancing figure)	1,52,500
To Balance c/d	4,00,000		
	4,82,500		4,82,500

So profit upto 1.4.2015, amounted to ₹ 38,125 (1/4th of ₹ 1,52,500, i.e., for 3 months) and net profit as on 1.4.2015 will be :

Profit on 1.1.2015		3,30,000
Proportionate Profit upto 31.3.2015	38,125	
Less: Interim Dividend for 3 months	37,500	625
Pre-acquisition Profit		3,30,625

(10) Entire accretion to General Reserve (i.e., ₹ 65,000 – ₹ 45,000 = ₹ 20,000) may be taken as post-acquisition profit, as the transfer was made on the date of account, i.e., 31st December, 2015.

Post-acquisition profit will be calculated as follows :

	₹
Share of current year's profit (9/12 × ₹ 1,52,500)	1,14,375
Less: Interim Dividend for 2 months (₹ 62,500 / 5 × 2)	25,000
	89,375
Less: Transferred to General Reserve	20,000
Post-acquisition Profit	69,375

Alternatively,

Profit as per Balance Sheet	4,00,000
Less: Pre-acquisition Profit (Note 9)	3,30,625
	69,375

Illustration 22

The Balance Sheets of Hari Ltd. and its subsidiary Suri Ltd. as at 31st March, 2016 are as follows :

Balance Sheets of Hari Ltd. and Suri Ltd. as at 31st March, 2016

Particulars	Note No.	Hari Ltd. (₹)	Suri Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		4,00,000	1,00,000
(b) Reserves and Surplus : General Reserve (1.4.2015)		2,80,000	34,000
Profit and Loss		1,70,000	42,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Creditors		70,000	35,000
TOTAL		9,20,000	2,11,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Plant and Machinery		4,80,000	90,000
Furniture		15,000	27,000
(b) Non-current Investments — 8,000 Equity Shares in Suri Ltd.		2,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		95,000	42,000
(c) Trade Receivables — Debtors		60,000	32,000
(d) Cash and Cash Equivalents — Cash at Bank		70,000	20,000
TOTAL		9,20,000	2,11,000

The following information is also given to you :

(i) Hari Ltd. acquired 8,000 equity shares in Suri Ltd. as at 1st July, 2015 at a cost of ₹ 2,00,000.

(ii) Stock of Hari Ltd. includes ₹ 6,000 relating to stock purchased from Suri Ltd. which follows the practice of charging 25% extra on the cost for determining the sale price.

(iii) Creditors of Hari Ltd. include ₹ 10,000 on account of purchases from Suri Ltd.

(iv) Profit and Loss Account of Hari Ltd. includes dividend @ 10% for the year 2015–16 received from Suri Ltd., which declared and paid it after 1st July, 2016.

(v) Balance in Suri Ltd.'s Profit and Loss Account on 1st April, 2015 was ₹ 26,000. Dividend @ 10% for the year 2014–15 was declared out of this balance after 1st July, 2015.

(vi) Profits during the year 2015-16 have been earned on uniform basis throughout the year.

Prepare a Consolidated Balance Sheet of Hari Ltd. and its subsidiary Suri Ltd. as at 31st March, 2016. Submit all your working notes neatly.

Solution

Consolidated Balance Sheet of Hari Ltd. and its Subsidiary Suri Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	4,00,000
(b) Reserves and Surplus	(2)	4,56,400
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	35,200
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	95,000
TOTAL		9,86,600
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	6,12,000
(ii) Intangible Assets	(5)	66,800
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,35,800
(c) Trade Receivables	(7)	82,000
(d) Cash and Cash Equivalents	(8)	90,000
TOTAL		9,86,600

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
40,000 Equity Shares of ₹ 10 each fully paid	4,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve (W.N. 6)	2,80,000
Profit and Loss Account (W.N. 5)	1,76,400
	4,56,400

(5) Fixed Assets

Particulars	₹
Tangible Assets	
Plant and Machinery (Chart 'C' - W.N. 4)	5,70,000
Furniture (Chart 'C' - W.N. 4)	42,000
	6,12,000
Intangible Assets :	
Goodwill (Chart 'B' - W.N. 3)	66,800

(6) Inventories

Particulars	₹
Stock-in-Trade	1,35,800

(3) Minority Interest		**(7) Trade Receivables**	
(Chart 'A')	35,200	Sundry Debtors	82,000
(4) Trade Payables		**(8) Cash and Cash Equivalents**	
Sundry Creditors	95,000	Cash in Hand (70,000 + 20,000)	90,000

Working Notes :

(1) Degree of Control = $\frac{8,000 \text{ Shares}}{10,000 \text{ Shares}}$ = 4/5th; Minority = 1/5th.

(2) Control Chart A : From the Balance Sheet of Suri Ltd.

Proprietary Balances	Notes	Total (₹)	Hari Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit				
1. Pre-acquisition Profit	7	32,500		
Less: Dividend for 2014-15		10,000		
		22,500		
2. Pre-acquisition General Reserve		34,000		
		56,500	45,200	11,300
(b) Post-acquisition Profit				
Profit as per Balance Sheet		42,000		
Less: Pre-acquisition Profit (a)		22,500		
		19,500	15,600	3,900
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		34,000		
Less: Pre-acquisition General Reserve		34,000		
		Nil	Nil	Nil
(d) Share Capital		1,00,000		
Less: Minority Interest (1/5)		20,000		20,000
		80,000		
Adjusted in Control Chart B		80,000		
Minority Interest				35,200

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		2,00,000
Less: Capital Profit	45,200	
Less: Dividend for 2014-15 (4/5th of ₹ 10,000)	8,000	
Less: Face Value of Shares held	80,000	1,33,200
Goodwill		66,800

(4) Control Chart C : Other Assets and Liabilities

Particulars	Plant and Machinery	Furniture	Stock	Debtors	Cash at Bank	Creditors
Hari	4,80,000	15,000	95,000	60,000	70,000	70,000
Suri	90,000	27,000	42,000	32,000	20,000	35,000
	—	—	1,37,000	92,000	—	1,05,000
Less: Mutual Indebtedness	—	—	—	10,000	—	10,000
Less : Unrealised Profit on Stock (Note 8)	—	—	1,200	—	—	—
	5,70,000	42,000	1,35,800	82,000	90,000	95,000

(5) Profit and Loss Account (Consolidated)	₹	(6) General Reserve	₹
Hari Ltd.	1,70,000	Hari Ltd.	2,80,000
Less: Dividend for 2014-04	8,000	Share from Suri Ltd.	Nil
	1,62,000		
Share of Post-acquisition Profit from Suri Ltd. (Chart A)	15,600		
	1,77,600		
Less: Unrealised Profit on Stock (Note 8)	1,200		
	1,76,400		2,80,000

Dr. (7) Profit and Loss Account of Suri Ltd. for the year ended 31st March, 2016 Cr.

To Dividend @ 10%	10,000	By Balance from last year	26,000
To Balance c/d	42,000	By Profit during the year (Balancing Figure)	26,000
	52,000		52,000

So, profit upto 30.6.2015, amounted to ₹ 6,500 (1/4 of ₹ 26,000 i.e. for 3 months) and the profit as on 30.6.2015 will be:

Profit on 1.4.2015	₹ 26,000
Proportionate Profit upto 30.6.2015	₹ 6,500
	₹ 32,500

(8) **Calculation of Unrealised Profit on Unsold Stock**
Suri Ltd. sold goods to Hari Ltd. for ₹ 6,000 at a profit of 25% on cost. Suri Ltd. made a profit of ₹ 1,200 (25/125 × ₹ 6,000). **As per AS—21 entire unrealised profit on stock is to be eliminated**.

Illustration 23

The following are the Balance Sheets of M Ltd. and N Ltd. as at 31.12.2015:

Balance Sheets of M Ltd. and N Ltd. as at 31st December, 2015

Particulars	Note No.	M Ltd. (₹)	N Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		3,00,000	2,00,000
(b) Reserves and Surplus : Capital Redemption Reserve		1,20,000	—
General Reserve		1,00,000	30,000
Profit and loss Account (Before any appropriation)		60,000	40,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — — 15% Debentures		2,00,000	1,00,000
(4) Current Liabilities :			
(a) Other Current Liabilities :			
Outstanding Interest on Debentures		30,000	15,000
Other Liabilities		1,90,000	1,15,000
TOTAL		10,00,000	5,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant		6,00,000	3,40,000
(b) Non-current Investments :			
15,000 Equity Shares in N Ltd. (30.6.2015)		2,00,000	—
Debentures in N Ltd. at par		50,000	—
Debentures in M Ltd. at par		—	60,000
(2) Current Assets :			
Other Current Investments		1,50,000	1,00,000
TOTAL		10,00,000	5,00,000

Prepare the Consolidated Balance Sheet as at 31.12.2015 assuming that N Ltd. has earned uniformly in 2015 and its Profit and Loss Account showed a debit balance of ₹ 20,000 on 1.1.2015. Show the workings also.

Solution

Consolidated Balance Sheet of M Ltd. and its Subsidiary N Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,00,000
(b) Reserves and Surplus	(2)	3,02,500
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	67,500
(4) Non-current Liabilities :		
(a) Long-term Borrowings	(4)	1,90,000
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(5)	3,33,500
TOTAL		11,93,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	9,40,000
(ii) Intangible Assets	(6)	20,000
(2) Current Assets :		
(a) Other Current Assets		2,33,500
TOTAL		11,93,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
30,000 Equity Shares of ₹ 10 each fully paid	3,00,000

(2) Reserve and Surplus

Capital Redemption Reserve	1,20,000
General Reserve	1,00,000
Profit and Loss Account (W.N. 7)	*82,500
	3,02,500

(3) Minority Interest

(Chart 'A' - W.N. 3)	67,500

(4) Long-term Borrowings

Debentures (W.N. 4)	1,90,000

(5) Other Current Liabilities

Particulars		₹
Other Liabilities (W.N. 4)		3,05,000
Outstanding Interest on Debentures :		
M Ltd	30,000	
Less: Due to N Ltd	9,000	21,000
N Ltd	15,000	
Less: Due to M Ltd	7,500	7,500
		3,33,500

(6) Fixed Assets

Tangible assets :	
Plant	9,40,000
Intangible Assets :	
Goodwill (Chart 'B' - W.N. 3)	20,000

(7) Other Current Assets *2,33,500

* It is assumed that both the companies have credited their respective share of interest on Debentures to Profit and Loss Account. Other current assets include accrued interest on Debentures of ₹ 16,500 (₹ 9,000 + ₹ 7,500).

On the other hand, if it is assumed that the accrued interest has not been adjusted, then the following adjustment entry is to be passed:

Accrued Interest on Debenture Account	Dr.	₹ 16,500	
To Profit and Loss Account			₹ 16,500

Working Notes :

(1) Degree of Control = $\frac{15,000 \text{ Shares}}{20,000 \text{ Shares}}$ = 3/4th; Minority = 1/4th.

(2) Control Chart A : From the Balance Sheet of N Ltd.

Proprietary Balances	Notes	Total (₹)	M Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
1. Pre-acquisition Profit	5	10,000		
2. Pre-acquisition General Reserve		30,000		
		40,000	30,000	10,000
(b) Post-acquisition Profit				
Profit as per Balance Sheet		40,000		
Less: Pre-acquisition Profit		10,000		
		30,000	22,500	7,500
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		30,000		
Less: Pre-acquisition General Reserve		30,000		
		Nil	Nil	Nil
(d) Share Capital		2,00,000		
Less : Minority Interest (1/4)		50,000		50,000
		1,50,000		
Adjusted in Control Chart B		1,50,000		
Minority Interest				67,500

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		2,00,000
Less: Capital Profit	30,000	
Less: Face Value of Shares held	1,50,000	1,80,000
Goodwill		20,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	Plant	Other Assets	Other Liabilities	Outstanding Interest on Debentures	Debentures
M Ltd.	6,00,000	1,50,000	1,90,000	30,000	2,00,000
N Ltd.	3,40,000	1,00,000	1,15,000	15,000	1,00,000
	—	2,50,000		45,000	3,00,000
Less: Held within the Group	—	—	—	—	1,10,000
Less : Accrued Interest on Debentures	—	*16,500	—	*16,500	—
	9,40,000	2,33,500	3,05,000	28,500	1,90,000

* ₹ 9,000 + ₹ 7,500 = ₹ 16,500.

Dr. **(5) Profit and Loss Account of N Ltd.** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	20,000	31.12.2015	By Net Profit (2015)	60,000
31.12.2015	To Balance c/d	40,000			
		60,000			60,000

(6) Pre-acquisition Profit = Opening balance of ₹ 20,000 (Dr.) + 1/2 of ₹ 60,000 = ₹ 20,000 (Dr.) + ₹ 30,000 = ₹ 10,000 (Cr.)

Tutorial Note : Shares were acquired on 30.6.2015. So, 1/2 of the profit of 2015 will be treated as pre-acquisition profit.

(7) Profit and Loss Account (Consolidated)	₹	(8) General Reserve	₹
M Ltd.	60,000	M Ltd.	1,00,000
Share of Post-acquisition Profit from N Ltd. (Chart A)	22,500	Share from N Ltd.	Nil
	82,500		1,00,000

Tutorial Note : Inter-cancellation of Debentures has been made on the lines of general practice and commercial expediency. However, it must be appreciated that Debenture is a statutory liability on the part of the issuing company and for investing company it is an asset, transferrable any time for value. Therefore, such cancellation, from legal point of view, is not a sound practice.

Illustration 24

The following are two Balance Sheets of H Ltd. and its subsidiary S Ltd. as on 31.12.2015 :

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		10,00,000	5,00,000
(b) Reserves and Surplus : General Reserve (1.1.2015)		1,00,000	50,000
Profit and Loss Account		2,40,000	1,10,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		1,50,000	70,000
TOTAL		14,90,000	7,30,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building (at cost)		3,10,000	1,60,000
Machinery at cost less 10% Depreciation		2,70,000	1,35,000
(b) Non-current Investments — 3,000 Equity Shares in S Ltd.		4,50,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories — Stock at cost		2,20,000	1,50,000
(c) Trade Receivables — Debtors		1,55,000	90,000
(d) Cash and Cash Equivalents — Cash at Bank		85,000	1,95,000
TOTAL		14,90,000	7,30,000

The following information is given :

(i) Profits of H Ltd. for the year 2015 have been ₹ 2,00,000.

(ii) Profits of S Ltd. for the year 2015 have been ₹ 80,000.

(iii) The 3,000 shares in S Ltd. were acquired by H Ltd. on 30.6.2015 when the values of land and buildings and machinery of S Ltd. were estimated to be ₹ 1,50,000 and ₹ 1,92,500 respectively.

Prepare a Consolidated Balance Sheet.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	10,00,000
(b) Reserves and Surplus	(2)	3,64,656
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	2,46,969
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	2,20,000
(c) Other Current Liabilities	(5)	10,000
TOTAL		18,41,625
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	9,12,875
(ii) Intangible Assets	(6)	33,750
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	3,70,000
(c) Trade Receivables	(8)	2,45,000
(d) Cash and Cash Equivalents	(9)	2,80,000
TOTAL		18,41,625

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
1,00,000 Equity Shares of ₹ 10 each fully paid	10,00,000

(2) Reserve and Surplus

Particulars	₹
General Reserve (Chart 'C' - W.N. 4)	1,00,000
Profit and Loss Account (Chart 'C' - W.N. 4)	2,64,656
	3,64,656

(3) Minority Interest

Particulars	₹
(Chart 'A' - W.N. 2)	2,46,969

(4) Trade Payables

Particulars	₹
Sundry Creditors (Chart 'C' - W.N. 4)	2,20,000

(5) Other Current Liabilities

Particulars	₹
Preference Dividend	10,000

(6) Fixed Assets

Particulars	₹
Tangible assets :	
Land and Building (Chart 'C' - W.N. 4)	4,60,000
Machinery (Chart 'C' - W.N. 4)	4,52,875
	9,12,875
Intangible Assets :	
Goodwill	33,750

(7) Inventories

Particulars	₹
Stock (W.N. 4)	3,70,000

(8) Trade Receivables

Particulars	₹
Sundry Debtors (Chart 'C' - W.N. 4)	2,45,000

(9) Cash and Cash Equivalents

Particulars	₹
Cash at Bank (Chart 'C' - W.N. 4)	2,80,000

Working Notes :

(1) Degree of Control = $\frac{3{,}000 \text{ Shares}}{4{,}000 \text{ Shares}}$ = 3/4th; Minority = 1/4th.

(2) Control Chart A : From the Balance Sheet of S Ltd.

Proprietary Balances	Notes	Total (₹)	H Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
1. Pre-acquisition Profit	5	65,000		
2. Pre-acquisition General Reserve		50,000		
3. Revaluation Profit on Machinery	6	50,000		
4. Revaluation Loss on Land and Building	8	(10,000)		
		1,55,000	1,16,250	38,750
(b) Post-acquisition Profit				
1/2 of the Profit earned during 2015		40,000		
Less: Preference Dividend for 1/2 year	7	5,000		
		35,000		
Less: Additional Depreciation		2,125		
		32,875	24,656	8,219
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		50,000		
Less: Pre-acquisition General Reserve		50,000		
		Nil	Nil	Nil
(d) Share Capital				
Equity		4,00,000		
Preference		1,00,000		
		5,00,000		
Less : Minority Interest (₹ 1,00,000 + ₹ 1,00,000)		2,00,000		2,00,000
		3,00,000		
Adjusted in Control Chart B		3,00,000		
Minority Interest				2,46,969

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		4,50,000
Less: Capital Profit	1,16,250	
Less: Face Value of Shares held	3,00,000	4,16,250
Goodwill		33,750

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Buildings	Machinery	Stock	Debtors	Bank	Creditors	Profit & Loss A/c (Consold.)	General Reserve
H Ltd.	3,10,000	2,70,000	2,20,000	1,55,000	85,000	1,50,000	2,40,000	1,00,000
S Ltd.	1,60,000	1,35,000	1,50,000	90,000	1,95,000	70,000	*24,656	Nil
	4,70,000	4,05,000	—	—	—	—	—	—
Less: Revaluation Loss	10,000	—	—	—	—	—	—	—
Add : Revaluation Profit (Note 6)	—	50,000	—	—	—	—	—	—
	—	4,55,000	—	—	—	—	—	—
Less: Addl. Depreciation (7)	—	2,125	—	—	—	—	—	—
	4,60,000	4,52,875	3,70,000	2,45,000	2,80,000	2,20,000	2,64,656	1,00,000

* Share of post-acquisition profit from S Ltd. (chart A)

(5) In 2015 S Ltd. earned a profit of ₹ 80,000. Profit upto the date of acquisition (30.6.2015) will be treated as pre-acquisition profit. Assuming that profit has been accrued evenly, the profit upto 30.6.2015 amounted to ₹ 40,000 (1/2 of ₹ 80,000). However, preference dividend for 6 months (upto 30.6.2015) ₹ 5,000 must be apportioned from this profit. So, profit after dividend of preference shares will be ₹ 40,000 – ₹ 5,000 = ₹ 35,000. The total pre-acquisition profit will be :

Profit on 1.1.2015 (₹ 1,10,000 – ₹ 80,000)	₹ 30,000
Proportionate Profit upto 30.6.2015 after preference dividend	₹ 35,000
	₹ 65,000

(6) On 31.12.2015 the value of machinery after 10% depreciation was ₹ 1,35,000. Therefore, the value of such machinery on 1.1.2015 was ₹ 1,35,000 / 90 × 100 = ₹ 1,50,000. Revaluation of machinery was done on 30.6.2015 and effective book value on that date was ₹ 1,42,500 (₹ 1,50,000 – 7,500 depreciation for 6 months). Therefore, Revaluation profit = ₹ 1,92,500 – ₹ 1,42,500 = ₹ 50,000.

(7) **Calculation of Additional Depreciation on Machinery**.
From 30.6.2015 to 31.12.2015, depreciation is to be provided @ 10% on ₹ 1,92,500 (revalued figure). So the depreciation of that period will be ₹ 9,625 (10% of ₹ 1,92,500 for 6 months).
However, depreciation has already been charged for this period = ₹ 7,500. Therefore, **additional depreciation** = ₹ 9,625 – ₹ 7,500 = ₹ 2,125.

(8) No depreciation has been charged on land and building. Therefore, its value on 1.1.2015 was same as on 31.12.2015. On 30.6.2015 it was revalued at ₹ 1,50,000. So, Revaluation Loss = ₹ 1,60,000 – ₹ 1,50,000 = ₹ 10,000.

Illustration 25

On 1st July, 2015 Maharaja Ltd. acquired 8,000 shares of ₹ 10 each of Praja Ltd. at ₹ 1,00,000. Their respective Balance Sheets on 31.12.2015 were as follows :

Balance Sheets of Maharaja Ltd. and Praja Ltd. as at 31st December, 2015

Particulars	Note No.	Maharaja Ltd. (₹)	Praja Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,00,000	1,00,000
(b) Reserves and Surplus : General Reserve		30,000	40,000
Profit and Loss Account		70,000	60,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables : Creditors		25,000	15,000
Bills Payable (Accepted — all are in favour of Maharaja Ltd.)		—	5,000
TOTAL		3,25,000	2,20,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Land and Building		1,00,000	1,00,000
(b) Non-current Investments — 8,000 Equity Shares of Praja Ltd.		1,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		50,000	40,000
(c) Trade Receivables :			
Debtors		65,000	70,000
Bills Receivable (Received from Praja ltd.)		5,000	—
(d) Cash and Cash Equivalents — Cash at Bank		5,000	10,000
TOTAL		3,25,000	2,20,000

Additional information :

(a) At the time of acquiring shares, Praja Ltd. had ₹ 15,000 in Reserve and on 1.1.2015 Praja Ltd. had ₹ 20,000 in Profit and Loss Account.

(b) Praja Ltd. paid 10% dividend in July for the year 2014 and Maharaja Ltd. credited the share of dividend to their Profit and Loss Account.

(c) On the date of acquisition of shares, Land and Building of Praja Ltd. stood at ₹ 1,20,000 on 1.1.2015 these were revalued at ₹ 1,40,000. Stock of Praja Ltd. includes ₹ 12,000 on which Maharaja Ltd. made a profit of 25% on sales.

(d) Proposed Dividend of both the companies for 2015 is 10%.

Prepare a Consolidated Balance Sheet as on 31st December, 2015.

Solution

Consolidated Balance Sheet of Maharaja Ltd. and its Subsidiary Praja Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	2,00,000
(b) Reserves and Surplus	(2)	1,51,666
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	43,667
(4) Non-current Liabilities :		—
(5) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	40,000
(c) Other Current Liabilities		—
(d) Short-term Provisions	(5)	30,000
TOTAL		4,65,333
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(6)	2,28,333
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(7)	87,000
(c) Trade Receivables	(8)	1,35,000
(d) Cash and Cash Equivalents	(9)	15,000
TOTAL		4,65,333

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000

(2) Reserve and Surplus

Capital Reserve (Chart 'B')	62,000
General Reserve (W.N. 6)	50,000
Profit and Loss Account (W.N. 5)	39,666
	1,51,666

(5) Short-term Provisions

Particulars	₹
Proposed Dividend :	
Maharaja Ltd	20,000
Share from Praja Ltd	8,000
	28,000
Add: Minority's Share	2,000
	30,000

(6) Fixed Assets

Tangible Assets :	
Land and Building (Chart 'C' - W.N. 4)	2,28,333

(3) Minority Interest		**(7) Inventories**	
(Chart 'A' - W.N. 2)	43,667	Stock	87,000
(4) Trade Payables		**(8) Trade Receivables**	
Creditors (Chart 'C' - W.N. 4)	40,000	Debtors	1,35,000
		Bills Receivables	—
			1,35,000
		(9) Cash and Cash Equivalents	
		Cash at Bank	15,000

Working Notes :

(1) Degree of Control = $\frac{8{,}000 \text{ Shares}}{10{,}000 \text{ Shares}}$ = 4/5th; Minority = 1/5th.

(2) Control Chart A : From the Balance Sheet of Praja Ltd.

Proprietary Balances	Notes	Total (₹)	Maharaja Ltd.'s Share (4/5)	Minority Interest (1/5)
(a) Capital Profit				
1. Pre-acquisition Profit	7	47,500		
2. Pre-acquisition Reserve		15,000		
3. Revaluation Profit	8	30,000		
		92,500	74,000	18,500
(b) Post-acquisition Profit				
Profit as per Balance Sheet		60,000		
Less: Pre-acquisition Profit		47,500		
		12,500		
Less: Additional Depreciation	9	1,667		
		10,833		
Less: Proposed Dividend		10,000	8,000	
		833	666	167
(c) Post-acquisition Reserve				
Reserve as per Balance Sheet		40,000		
Less: Pre-acquisition Reserve		15,000		
		25,000	20,000	5,000
(d) Share Capital		1,00,000		
Less : Minority Interest (1/5)		20,000		20,000
		80,000		
Adjusted in Control Chart B		80,000		
Minority Interest				43,667

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		1,00,000
Less: Capital Profit	74,000	
Less: Dividend for 2014 (4/5 of ₹ 10,000)	8,000	
Less: Face Value of Shares held	80,000	1,62,000
Capital Reserve		62,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	Land and Building	Stock	Debtors	Cash at Bank	Creditors	Bills Receivable	Bills Payable
Maharaja Ltd.	1,00,000	50,000	65,000	5,000	25,000	5,000	—
Praja Ltd.	1,00,000	40,000	70,000	10,000	15,000	—	5,000
	2,00,000	90,000	—	—	—	—	—
Add : Revaluation Profit (Note 8)	30,000	—	—	—	—	—	—
	2,30,000	—	—	—	—	—	—
Less: Additional Depreciation (Note 9)	1,667	—	—	—	—	—	—
	—	—	—	—	—	—	—
Less: Unrealised Profit (Note 10)	—	3,000	—	—	—	—	—
Less: Mutual Acceptance	—	—	—	—	—	5,000	5,000
	2,28,333	87,000	1,35,000	15,000	40,000	Nil	Nil

(5) Profit and Loss Account (Consolidated)

	₹
Maharaja Ltd.	70,000
Less: Dividend for 2014	8,000
	62,000
Less: Proposed Dividend	20,000
	42,000
Add: Share of post-acquisition profit from Praja Ltd.	666
	42,666
Less: Unrealised profit on unsold goods	3,000
	39,666

(6) General Reserve

	₹
Maharaja Ltd.	30,000
Add: Share of post-acquisition reserve	20,000
	50,000

Dr. (7) Profit and Loss Account of Praja Ltd. for the year ended 31st December, 2015 Cr.

To General Reserve (₹ 40,000 – ₹ 15,000)	25,000	By Balance from last year	20,000
To Dividend @ 10%	10,000	By Profit during the year (Balancing Figure)	75,000
To Balance c/d	60,000		
	95,000		95,000

Therefore, profit upto 30.6.2015, if accrued evenly, amounted to ₹ 37,500 (1/2 of ₹ 75,000) and profit as on 30.6.2015 will be :

Profit on 1.1.2015	₹ 20,000	
Less: Dividend for 2014	₹ 10,000	10,000
Proportionate profit upto 30.6.2015		37,500
		₹ 47,500

Entire accretion to General Reserve may be taken as current profit as the transfer was made on the date of account, i.e., 31.12.2015. Therefore, current profit will be ₹ 37,500 – ₹ 25,000 = ₹ 12,500 which is same as :

Profit and Loss Account

As per Balance Sheet	₹ 60,000
Less: Pre-acquisition profit	₹ 47,500
Post-acquisition profit	₹ 12,500

(8) Value of fixed assets on 31.12.2015 was ₹ 1,00,000. It was standing in the books at ₹ 1,20,000 on 1.1.2015. Therefore, total depreciation charged in 2015 = ₹ 20,000. Rate of depreciation = ₹ 20,000 / ₹ 1,20,000 × 100 = 16.67%.
The effective book value on 30.6.2015 was ₹ 1,20,000 – ₹ 10,000 (depreciation for 6 months @ 16.67% on ₹ 1,20,000) = ₹ 1,10,000. It was revalued at ₹ 1,40,000. Therefore, revaluation profit = ₹ 1,40,000 – ₹ 1,10,000 = ₹ 30,000.

(9) Calculation of Additional Depreciation on Fixed Assets
From 30.6.2015 to 31.12.2015, depreciation is to be provided @ 16.67% on ₹ 1,40,000. So, depreciation of that period will be ₹ 11,667 (16.67% on ₹ 1,40,000 for 6 months).
However, depreciation has already been provided for this period ₹ 10,000 (1/2 of ₹ 20,000). Therefore, additional depreciation = ₹ 1,667.

(10) Unrealised Profit on Unsold Stock
Total unrealised profit = 25% of ₹ 12,000 = ₹ 3,000. **As per AS—21 entire unrealised profit on stock is to be eliminated**.

Illustration 26

Jupiter Ltd. purchased control of Neptune Ltd. on 1.7.2015. Following are the Balance Sheets of two companies as at 31.12.2015:

Balance Sheets of Jupiter Ltd. and Neptune Ltd. as at 31st December, 2015

Particulars	Note No.	Jupiter Ltd. (₹)	Neptune Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		3,60,000	1,80,000
(b) Reserves and Surplus : General Reserve		36,000	30,000
Profit and Loss Account		60,000	60,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables :			
Sundry Creditors		60,000	42,000
Bills Payable to Jupiter Ltd.		—	6,000
TOTAL		5,16,000	3,18,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land		60,000	60,000
Plant and Machinery		1,20,000	1,08,000
(ii) Intangible Assets — Goodwill		6,000	24,000
(b) Non-current Investments — 13,500 Equity Shares of Neptune Ltd.		2,02,500	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		70,500	60,000
(c) Trade Receivables — Sundry Debtors		30,000	54,000
(d) Cash and Cash Equivalents — Cash at Bank		27,000	12,000
TOTAL		5,16,000	3,18,000

Neptune Ltd. had on 1.1.2015 ₹ 30,000 in General Reserve and ₹ 36,000 (Cr.) in Profit and Loss Account. 10% dividend was received by Jupiter Ltd. in July from Neptune Ltd. for 2014 and this amount was credited to the Profit and Loss Account of the Holding Company.

Plant and Machinery standing in the books of Neptune Ltd. at ₹ 1,20,000 on the date of purchase was revalued at ₹ 44,000. Stock of Neptune Ltd. included ₹ 9,600 on which Jupiter Ltd. made a profit of 25% on cost.

You are required to prepare a Consolidated Balance Sheet of Jupiter Ltd and its subsidiary Neptune Ltd as ar 31st December, 2015.

Solution

Consolidated Balance Sheet of Jupiter Ltd. and its Subsidiary Neptune Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	3,60,000
(b) Reserves and Surplus	(2)	92,180
(2) Share Application Money Pending Allotment :		—

(3) Minority Interest	(3)	50,950
(4) Non-current Liabilities :		
(5) Current Liabilities :		—
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	1,08,000
TOTAL		6,18,130
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	2,81,800
(ii) Intangible Assets	(5)	84,750
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	1,28,580
(c) Trade Receivables	(7)	84,000
(d) Cash and Cash Equivalents	(8)	39,000
TOTAL		6,18,130

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
36,000 Equity Shares of ₹ 10 each fully paid	3,60,000

(2) Reserve and Surplus

Particulars	₹
General Reserve (W.N. 6)	36,000
Profit and Loss Account (W.N. 5)	63,180
	99,180

(3) Minority Interest

Particulars	₹
(Chart 'A' - W.N. 2)	50,950

(4) Trade Payables

Particulars	₹
Sundry Creditors (Chart 'C' - W.N. 4)	1,02,000
Bills Payable (Chart 'C' - W.N. 4)	6,000
	1,08,000

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (Chart 'C' - W.N. 4)	1,20,000
Plant and Machinery (Chart 'C' - W.N. 4)	1.61,800
	2,81,800
Intangible Assets :	
Goodwill (Chart 'B' - W.N. 3)	84,750

(7) Inventories

Particulars	₹
Stock (Chart 'C' - W.N. 4)	1,28,580

(8) Trade Receivables

Particulars	₹
Sundry Debtors (Chart 'C' - W.N. 4)	84,000

(9) Cash and Cash Equivalents

Particulars	₹
Cash at Bank (Chart 'C' - W.N. 4)	39,000

Working Notes :

(1) Degree of Control = $\dfrac{13{,}500 \text{ Shares}}{18{,}000 \text{ Shares}}$ = 3/4th; Minority = 1/4th.

(2) Control Chart A : From the Balance Sheet of Neptune Ltd.

Proprietary Balances	Notes	Total (₹)	Jupiter Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
1. Pre-acquisition Profit	7	39,000		
2. Pre-acquisition General Reserve		30,000		
3. Revaluation Loss	8	(70,000)		
		(1,000)	(750)	(250)

(b) Post-acquisition Profit				
Profit as per Balance Sheet		60,000		
Less : Pre-acquisition Profit		39,000		
		21,000		
Add: Excess Depreciation	9	3,800		
		24,800	18,600	6,200
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		30,000		
Less: Pre-acquisition General Reserve		30,000		
		Nil	Nil	Nil
(d) Share Capital		1,80,000		
Less : Minority Interest (1/4)		45,000		45,000
		1,35,000		
Adjusted in Control Chart B		1,35,000		
Minority Interest				50,950

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		2,02,500
Less: Capital Profit	(750)	
Less: Dividend for 2014 (3/4 of ₹ 18,000)	13,500	
Less: Face Value of Shares held	1,35,000	1,47,750
Goodwill		54,750

(4) Control Chart C : Other Assets and Liabilities

	Goodwill	Land and Building	Plant and Machinery	Stock	Debtors	Bank	Creditors
Jupiter Ltd.	6,000	60,000	1,20,000	70,500	30,000	27,000	60,000
Neptune Ltd.	24,000	60,000	1,08,000	60,000	54,000	12,000	42,000
From Chart B	54,750	—	2,28,000	1,30,500	—	—	—
Less: Revaluation Loss (Note 8)	—	—	70,000	—	—	—	—
	—	—	1,58,000	—	—	—	—
Add: Excess Depreciation (Note 9)	—	—	3,800	—	—	—	—
Less: Unrealised Profit on Stock (Note 10)	—	—	—	1,920	—	—	—
	84,750	1,20,000	1,61,800	1,28,580	84,000	39,000	1,02,000

(5) Profit and Loss Account (Consolidated)	₹
Jupiter Ltd.	60,000
Less: Dividend for 2014	13,500
	46,500
Share of Post-acquisition Profit from Neptune Ltd. (Chart A)	18,600
	65,100
Less: Unrealised Profit on Stock (Note 10)	1,920
	63,180

(6) General Reserve	₹
Jupiter Ltd.	36,000
Share from Neptune Ltd.	Nil
	36,000

Dr. (7) Profit and Loss Account of Jupiter Ltd. for the year ended 31st December, 2015 Cr.

Particulars	₹	Particulars	₹
To Dividend for 2014	18,000	By Balance from last year	36,000
To Balance c/d	60,000	By Profit during the year (Balancing figure)	42,000
	78,000		78,000

Therefore, profit upto 30.6.2015 (assumed accrued evenly) amounted to ₹ 21,000 (1/2 of ₹ 42,000). Profit on 30.6.2015 will be :

Profit on 1.1.2015	₹ 36,000
Less: Dividend for 2014	₹ 18,000
	₹ 18,000
Add : Proportionate profit upto 30.6.2015	₹ 21,000
	₹ 39,000

(8) Value of Plant and Machinery on 31.12.2015 was ₹ 1,08,000. On 30.6.2015 it was standing in the books at ₹ 1,20,000. Assuming there is no additions during the year, the total depreciation charged in 2015 = ₹ 1,20,000 – ₹ 1,08,000 = ₹ 12,000. Rate of depreciation 12,000 / 1,20,000 × 100 = 10%.
The effective book value on 30.6.2015 was ₹ 1,20,000 – ₹ 6,000 (depreciation for 6 months @ 10% on ₹ 1,20,000) = ₹ 1,14,000. It was revalued at ₹ 44,000. Therefore, **revaluation loss** = ₹ 1,14,000 – ₹ 44,000 = ₹ 70,000.

(9) Calculation of Excess Depreciation on Plant and Machinery
From 30.6.2015 to 31.12.2015, depreciation is to be provided @ 10% on ₹ 44,000. So, the depreciation of that period will be ₹ 2,200 (10% on ₹ 44,000 for 6 months).
However, depreciation has already been charged for this period = ₹ 6,000 (1/2 of ₹ 12,000).
Therefore, excess depreciation = ₹ 3,800.

(10) Unrealised Profit on Unsold Stock
Total unrealised profit = 25/125 × ₹ 9,600 = ₹ 1,920. **As per AS—21 entire unrealised profit on stock is to be eliminated**.

Illustration 27

Following are the Balance Sheets of Calcutta Ltd. and Howrah Ltd. as at 31st December, 2015 :

Balance Sheets of Calcutta Ltd. and Howrah Ltd. as at 31st December, 2015

Particulars	Note No.	Calcutta Ltd. (₹)	Howrah Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		15,00,000	6,00,000
(b) Reserves and Surplus : General Reserve		3,00,000	1,80,000
Profit and Loss Account		4,20,000	2,70,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		2,31,000	1,50,000
Bills Payable		—	1,20,000
(c) Due to Howrah Ltd.		9,000	—
TOTAL		24,60,000	13,20,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		6,00,000	3,90,000
Plant and Machinery		4,80,000	2,70,000
(ii) Intangible Assets — goodwill		1,20,000	90,000
(b) Non-current Investments — 4,500 Equity Shares of Howrah Ltd.		7,20,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock		3,00,000	2,70,000
(c) Trade Receivables — Sundry Debtors		60,000	2,25,000
(d) Cash and Cash Equivalents — Cash at Bank		1,80,000	60,000
(e) Due from Calcutta Ltd.		—	15,000
TOTAL		24,60,000	13,20,000

Other particulars :

(a) The Profit and Loss Account of Howrah Ltd. showed a balance of ₹ 1,50,000 on 1st January 2015. A dividend of 15% was paid in October 2015 for the year 2014. This dividend was credited to the Profit and Loss Account by Calcutta Ltd. Calcutta Ltd. acquired the shares in Howrah Ltd. on 1st July, 2015.

(b) The bills payable by Howrah Ltd. were all issued in favour of Calcutta Ltd., which had got the bills discounted.

(c) The creditors of Howrah Ltd. included ₹ 60,000 for goods supplied by Calcutta Ltd.

(d) Included in the stock of Howrah Ltd. are goods to the value of ₹ 24,000 which were supplied by Calcutta Ltd. at a profit of $33^1/_3\%$ on cost.

(e) At the date of acquisition of shares, Plant and Machinery standing at ₹ 3,00,000 in Howrah Ltd's. books were revalued at ₹ 4,50,000 but no adjustment was made in the books.

(f) Calcutta Ltd. remitted ₹ 6,000 on December 30, 2015 but it was received by Howrah Ltd. on 4th January, 2016.

You are required to draw up a Consolidated Balance Sheet of Calcutta Ltd. and its subsidiary Howrah Ltd.

* Alternatively, entire capital reserve can be adjusted against goodwill.

Solution

Consolidated Balance Sheet of Calcutta Ltd. and its Subsidiary Howrah Ltd. as at 31st December, 2015

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	15,00,000
(b) Reserves and Surplus	(2)	8,99,625
(2) Share Application Money Pending Allotment :		—
(3) Minority Interest	(3)	3,01,875
(4) Non-current Liabilities :		
(5) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables	(4)	4,41,000
TOTAL		31,42,500
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	18,97,500
(ii) Intangible Assets	(5)	2,10,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories	(6)	5,64,000
(c) Trade Receivables	(7)	2,25,000
(d) Cash and Cash Equivalents	(8)	2,46,000
TOTAL		31,42,500

Notes to Accounts :

(1) Share Capital

Particulars	₹
Authorised Capital :	
? Equity Shares of ? each	?
Issued, Subscribed and Paid-up Capital :	
15,000 Equity Shares of ₹ 100 each fully paid	15,00,000

(2) Reserve and Surplus

Particulars	₹
Capital Reserve (Chart 'B')	1,80,000
General Reserve (W.N. 6)	3,00,000
Profit and Loss Account (W.N. 5)	4,19,625
	8,99,625

(3) Minority Interest

Particulars	₹
(Chart 'A' - W.N. 2)	3,01,875

(5) Fixed Assets

Particulars	₹
Tangible Assets :	
Land and Building (Chart 'C')	9,90,000
Plant and Machinery (Chart 'C')	9,07,500
	18,97,500
Intangible Assets :	
Goodwill (Chart 'C')	2,10,000

(6) Inventories

Particulars	₹
Chart 'C'	5,64,000

(7) Trade Receivables

Particulars	₹
Sundry Debtors	2,25,000

(4) Trade Payables		**(8) Cash and Cash Equivalents**	
Sundry Creditors	3,21,000	Cash at Bank	2,40,000
Bills Payable	1,20,000	Cash in Transit	6,000
	4,41,000		2,46,000

Working Notes :

(1) Degree of Control = $\frac{4{,}500 \text{ Shares}}{6{,}000 \text{ Shares}}$ = 3/4th; Minority = 1/4th.

(2) Control Chart A : From the Balance Sheet of Howrah Ltd.

Proprietary Balances	Notes	Total (₹)	Calcutta Ltd.'s Share (3/4)	Minority Interest (1/4)
(a) Capital Profit				
1. Pre-acquisition Profit	7	1,65,000		
2. Pre-acquisition General Reserve		1,80,000		
3. Revaluation Profit	8	1,65,000		
		5,10,000	3,82,500	1,27,500
(b) Post-acquisition Profit				
Profit as per Balance Sheet		2,70,000		
Less: Pre-acquisition Profit		1,65,000		
		1,05,000		
Less: Short Depreciation	9	7,500		
		97,500	73,125	24,375
(c) Post-acquisition General Reserve				
General Reserve as per Balance Sheet		1,80,000		
Less: Pre-acquisition General Reserve		1,80,000		
		Nil	Nil	Nil
(d) Share Capital		6,00,000		
Less : Minority Interest (1/4)		1,50,000		1,50,000
		4,50,000		
Adjusted in Control Chart B		4,50,000		
Minority Interest				3,01,875

(3) Control Chart B : Calculation of Goodwill/Capital Reserve

	₹	₹
Cost of Investments		7,20,000
Less: Capital Profit	3,82,500	
Less: Dividend for 2014 (3/4 of ₹ 90,000)	67,500	
Less: Face Value of Shares held	4,50,000	9,00,000
Capital Reserve		1,80,000

(4) Control Chart C : Other Assets and Liabilities

Particulars	Goodwill	Land and Building	Plant and Machinery	Stock	Due from Calcutta Ltd.	Due from Howrah Ltd.	Debtors	Creditors
Calcutta Ltd.	1,20,000	6,00,000	4,80,000	3,00,000	—	9,000	60,000	2,31,000
Howrah Ltd.	90,000	3,90,000	2,70,000	2,70,000	15,000	—	2,25,000	1,50,000
	—	—	7,50,000	5,70,000	15,000	—	2,85,000	3,81,000
Add: Revaluation Profit (8)	—	—	1,65,000	—	—	—		—
	—	—	9,15,000	—	—	—		—
Add: Addl. Depreciation (7)	—	—	7,500	—	—	—		—
Less: Unrealised Profit on Stock (Note 10)	—	—	—	6,000	—	—		—
Less: Cash-in-transit	—	—	—	—	6,000	—		—
					9,000	9,000		—
Less: Mutual Indebtedness	—	—	—	—	9,000	9,000	60,000	60,000
	2,10,000	9,90,000	9,07,500	5,64,000	Nil	Nil	2,25,000	3,21,000

(5) Profit and Loss Account (Consolidated)	₹	**(6) General Reserve**	₹
Calcutta Ltd.	4,20,000	Calcutta Ltd.	3,00,000
Less: Dividend for 2014 wrongly credited	67,500	Share from Howrah Ltd.	Nil
	3,52,500		
Add: Share of Post-acquisition Profit from Howrah Ltd.	73,125		
	4,25,625		
Less: Unrealised Profit on Stock	6,000		
	4,19,625		3,00,000

Dr. (7) Profit and Loss Account of Howrah Ltd. for the year ended 31st December, 2015 Cr.

To Dividend for 2014	90,000	By Balance from Last year	1,50,000
To Balance c/d	2,70,000	By Profit during the year (Balancing Figure)	2,10,000
	3,60,000		3,60,000

Therefore, profit upto 30.6.2015 (assumed accrued evenly) amounted to ₹ 1,05,000 (1/2 of ₹ 2,10,000). Profit on 30.6.2015 will be:

Profit on 1.1.2015	₹ 1,50,000
Less: Dividend for 2014	₹ 90,000
	₹ 60,000
Add : Proportionate profit upto 30.6.2015	₹ 1,05,000
	₹ 1,65,000

(8) Value of Plant and Machinery on 31.12.2015 was ₹ 2,70,000. On 30.6.2015, it was standing in the books at ₹ 3,00,000. Assuming that there was no addition during the year, the total depreciation charged in 2015 : ₹ 3,00,000 – ₹ 2,70,000 = ₹ 30,000. Rate of depreciation = ₹ 30,000 / ₹ 3,00,000 × 100 = 10%.
The effective book value on 30.6.2015 was ₹ 3,00,000 – ₹ 15,000 (depreciation upto 30.6.2015 @ 10% on ₹ 3,00,000) = ₹ 2,85,000. It was revalued at ₹ 4,50,000. Therefore, the revaluation profit = ₹ 4,50,000 – ₹ 2,85,000 = ₹ 1,65,000.

(9) Calculation of Additional Depreciation on Plant and Machinery
From 30.6.2015 to 31.12.2015, depreciation is to be provided @ 10% on ₹ 4,50,000 (revalued figure). So, the depreciation of that period will be ₹ 22,500 (10% of ₹ 4,50,000 for 6 months).
However, depreciation has already been charged for this period ₹ 15,000 (1/2 of ₹ 30,000). Therefore, additional depreciation = ₹ 22,500 – ₹ 15,000 = ₹ 7,500.

(10) Unrealised Profit on Unsold Stock
Total unrealised profit = $33^1/_3 / 133^1/_3 \times$ ₹ 24,000 = ₹ 6,000. **As per AS—21 entire unrealised profit on stock is to be eliminated**.

KEY POINTS

- Section 129(3) of the Companies Act, 2013 requires that a company having one or more subsidiary, shall prepare a ***Consolidated Financial Statement*** (CFS) of the company and of all the subsidiaries in the same forms and manner as ***Standalone Financial Statement*** (SFS) of the parent company.
- Accounting Standard (AS) — 21 'Consolidated Financial Statements' defined 'subsidiary' and 'parent' as:
A ***subsidiary*** is an enterprise that is controlled by another enterprise (known as the 'parent').
Parent enterprise is an enterprise that has one or more subsidiaries.

THEORETICAL QUESTIONS

1. What is a holding company ? How does a holding company come into existence ?
2. What do you understand by the expression "consolidation of financial statements". State the advantages and disadvantages of consolidation of financial statements.
3. How do you evaluate 'minority interest' ? Is it a liability of the group ?
4. What do you understand by "cancellation of inter-company debts and acceptances" ? — Discuss with examples.
5. What are the forms and techniques of preparing a Consolidated Balance Sheet ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Degree of control depends upon holding of
   A equity shares only;
   B both equity shares and preference shares
   C both preference shares and debentures.
2. At the time of consolidation, profit on revaluation of fixed assets of the subsidiary company is treated as
   A revenue profit;
   B capital profit
   C none of the above.
3. Dividend paid by the subsidiary company out of post-acquisition profit is credited to
   A investment account of the holding company;
   B profit and loss account of the holding company
   C capital reserve account of the holding company.
4. Minority interest is shown in the consolidated balance sheet
   A under share capital;
   B under reserve and surplus
   C as a separate item.
5. Unrealised profits resulting from intergroup transactions that are included in carrying amount of assets are eliminated
   A in full, irrespective of percentage of holding;
   B partly, depending upon the percentage of holding
   C none of the above.

PRACTICAL QUESTIONS

1. From the Balance Sheets given below, prepare a Consolidated Balance Sheet of X Co. Ltd. and its subsidiary Y Co. Ltd. The interests of the minority shareholders of Y Co. Ltd. are to be shown in the Consolidated Balance Sheet.

Balance Sheets of X Ltd. and Y Ltd. as at 31st March, 2016

Particulars	Note No.	X Ltd. (₹)	Y Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 80 each		1,60,00,000	16,00,000
(b) Reserves and Surplus : General Reserve		80,00,000	—
Profit and Loss Account		16,00,000	24,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables — Sundry Creditors		48,00,000	3,20,000
TOTAL		3,04,00,000	43,20,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			—
Land and Building		1,52,00,000	3,20,000
Plant and machinery		22,40,000	
(b) Non-current Investments — 18,000 Equity Shares of ₹ 80 each		28,80,000	—

(2) Current Assets :			
(a) Current Investments			
(b) Inventories		48,00,000	8,00,000
(c) Trade Receivables		32,00,000	11,20,000
(d) Cash and Cash Equivalents — Cash at Bank		20,80,000	20,80,000
TOTAL		3,04,00,000	43,20,000

2. From the following Balance Sheets of H Ltd. and its subsidiary S Ltd. drawn up at 31st December 2015, prepare a Consolidated Balance Sheet. At the date of acquisition of shares, the General Reserve of S Ltd. amounted to ₹ 20,000 and the Profit and Loss Account balance to ₹ 40,000 (Cr.)

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		10,00,000	4,00,000
(b) Reserves and Surplus : General Reserve		1,00,000	20,000
Profit and Loss Account		1,50,000	60,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		1,50,000	40,000
TOTAL		14,00,000	5,20,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets : Freehold Property at Cost		2,00,000	—
Plant and Machinery		2,50,000	2,00,000
(b) Non-current Investments — 30,000 Equity Shares of S Ltd.		4,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories at Cost		1,50,000	2,00,000
(c) Trade Receivables		2,00,000	20,000
(d) Cash and Cash Equivalents — Cash at Bank		2,00,000	1,00,000
TOTAL		14,00,000	5,20,000

3. H Ltd. acquired 80% of both classes of shares of S Ltd. on 1.1.2015 at a total cost cost of ₹ 1,00,000. The Balance Sheets of the two companies as on 31.12.2015 are given below :

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	4,00,000	1,00,000
(b) Reserves and Surplus : General Reserve (1.1.2015)		50,000	30,000
Profit and Loss Account		20,000	10,000

(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Sundry Creditors		30,000	20,000
TOTAL		5,00,000	1,60,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		2,50,000	1,40,000
(b) Non-current Investments — Shares in S Ltd.		1,00,000	—
(2) Current Assets :			
Other Current Investments		1,50,000	20,000
TOTAL		5,00,000	1,60,000

Notes to Accounts :

(1) Share Capital

Particulars	H Ltd. ₹ in Lakhs	S Ltd. ₹ in Lakhs
Issued, Subscribed and Paid-up Capital :		
40,000 Equity Shares of ₹ 10 each fully paid	4,00,000	—
8%, 5,000 Preference Shares of ₹ 10 each	—	50,000
5,000 Equity Shares of ₹ 10 each	—	50,800
	4,00,000	1,00,000

S Ltd. had ₹ 5,000 in Profit and Loss Account as on 1.1.2015. The dividend in respect of preference shares for 2015 is still payable. Prepare a Consolidated Balance Sheet as at 31.12.2015.

4. The following are the summarised Balance Sheets of A Ltd. and its subsidiary B Ltd. as on 31.12.2015 :

Balance Sheets of A Ltd. and B Ltd. as at 31st December, 2015

Particulars	Note No.	A Ltd. (₹)	B Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	5,00,000	1,00,000
(b) Reserves and Surplus — General Reserve		10,000	40,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payables : Sundry Creditors		20,000	30,000
Bills Payable		—	5,000
TOTAL		5,30,000	1,75,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		1,00,000	40,000
Plant and Machinery		1,00,000	50,000
(b) Non-current Investments — 7,500 Equity Shares of B Ltd. at cost		80,000	—
(2) Current Assets :			
(a) Inventories		90,000	30,000
(b) Trade Receivables :			
Sundry Debtors		40,000	30,000
Bills Receivable		5,000	—
(c) Cash and Cash Equivalents		1,15,000	25,000
TOTAL		5,30,000	1,75,000

Notes to Accounts :

(1) Share Capital

Particulars	H Ltd. ₹ in Lakhs	S Ltd. ₹ in Lakhs
Issued, Subscribed and Paid-up Capital :		
5,000 Equity Shares of ₹ 100 each fully paid	5,00,000	—
10,000 Equity Shares of ₹ 10 each fully paid	—	1,00,000
	5,00,000	1,00,000

A Ltd. acquired shares in B Ltd. on 1.1.2015 when B Ltd. had 10,000 in General Reserve. No dividend has been declared by B Ltd. in 2015. All bills receivable of A Ltd. are drawn on B Ltd.

You are asked to prepare a Consolidated Balance Sheet of A Ltd. and its subsidiary B Ltd. as on 31.12.2015.

5. H Ltd. acquired 40,000 Equity Shares of S Ltd. on 1st January, 2015. The following are the Balance Sheets of the two companies as at 31st December, 2015:

Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	H Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		10,00,000	5,00,000
(b) Reserves and Surplus :			
General Reserve (1.1.2015)		1,00,000	1,00,000
Profit and Loss Balance (1.1.2015)		50,000	30,000
Profits for the year 2015		60,000	40,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
Trade Payables :			
Sundry Creditors		70,000	50,000
Bills Payable		10,000	5,000
TOTAL		12,90,000	7,25,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		2,00,000	1,50,000
Plant and Machinery		3,00,000	3,00,000
(b) Non-current Investments — 40,000 Equity Shares in S Ltd.		5,00,000	—
(2) Current Assets :			
(a) Inventories		75,000	50,000
(b) Trade Receivables : Sundry Debtors		50,000	60,000
Bills Receivable		10,000	5,000
(c) Cash and Cash Equivalents — Cash at Bank		1,55,000	1,60,000
TOTAL		12,90,000	7,25,000

(i) Bills receivables of H ltd. include ₹ 3,000 accepted by S Ltd.

(ii) Sundry Debtors of H Ltd. include ₹ 10,000 due from S Ltd.

(iii) Stock of S Ltd. include goods purchased from H Ltd. for ₹ 30,000 which were invoiced by H Ltd. at a profit of 25% on the invoice price.

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st December, 2015.

6. P Ltd. acquired 6,000 Equity Shares of ₹ 10 each in S Ltd. on December 31, 2015. The summarised Balance Sheets of P Ltd. and S Ltd. as on that date were :

Balance Sheets of P Ltd. and S Ltd. as at 31st December, 2015

Particulars	Note No.	P Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	3,00,000	80,000
(b) Reserves and Surplus	(2)	70,000	54,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables:			
Sundry Creditors		35,000	17,500
Bills Payable (Including ₹ 1,000 to P Ltd.)		—	3,500
TOTAL		4,05,000	1,55,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		2,53,000	1,28,000
(b) Non-current Investments — 6,000 Equity Shares in S Ltd.		1,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		30,000	10,000
(c) Trade Receivables — Bills Receivable (including ₹ 1,000 from S Ltd.)		2,000	—
(d) Cash and Cash Equivalents — Cash in Hand		20,000	17,000
TOTAL		4,05,000	1,55,000

Notes to Accounts :

(1) Share Capital

Particulars	P Ltd. ₹ in Lakhs	S Ltd. ₹ in Lakhs
Authorised Capital :		
80,000 Equity Shares of 5 each	4,00,000	—
12,000 Shares of ₹ 10 each	—	1,20,000
	4,00,000	1,20,000
Issued, Subscribed and Paid-up Capital :		
60,000 Equity Shares of ₹ 5 each fully paid	3,00,000	—
8,000 Equity Shares of ₹ 10 each	—	80,000
	3,00,000	80,000

(2) Reserve and Surplus

Capital Reserve	—	34,000
General Reserve	20,000	10,000
Profit and Loss Account	50,000	10,000
	70,000	54,000

Note : (Ref : Balance Sheet of P Ltd.) Contingent Liability for Bills Discounted ₹ 1,200.
On 1.1.2016, S Ltd. utilised part of its capital reserve to make a bonus issue of one share for every four shares held. You are required to prepare the Consolidated Balance Sheet as on 1.1.2016 and show therein how your figures are made up.

7. Following are the summarised Balance Sheets of Imperial Co. Ltd. and Colonial Co. Ltd. as on December 31, 2015:

Balance Sheets of Imperial Co. Ltd. and Colonial Co. Ltd. as at 31st December, 2015

Particulars	Note No.	Imperial Co. Ltd. (₹)	Colonial Co. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		10,00,000	3,00,000
(b) Reserves and Surplus : General Reserve		4,00,000	1,25,000
Profit and Loss Account		3,00,000	1,75,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		1,00,000	70,000
TOTAL		18,00,000	6,70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Freehold Premises		4,50,000	1,20,000
Plant and Machinery		3,50,000	1,60,000
Furniture		80,000	30,000
(b) Non-current Investments — 20,000 Equity Shares in Colonial Co. Ltd.		2,60,000	—
(2) Current Assets :			
(a) Current Investments		—	
(b) Inventories		3,20,000	1,60,000
(c) Trade Receivables		3,00,000	1,70,000
(d) Cash and Cash Equivalents — Cash at Bank		40,000	30,000
TOTAL		18,00,000	6,70,000

You are required to prepare a Consolidated Balance Sheet as on 31.12.2015 showing in detail necessary adjustments and taking into consideration the following information:

(a) Imperial Co. Ltd. acquired the shares of Colonial Co. Ltd. on 1.1.2015 when the balances on their Profit and Loss Account and General Reserve were ₹ 75,000 and ₹ 80,000 respectively.

(b) Stock of ₹ 1,60,000 held by Colonial Co. Ltd. consists of ₹ 60,000 goods purchased from Imperial Co. Ltd. who has charged profit at 25% on cost.

8. From the following Balance Sheet of a holding company and its subsidiary as on March 31, 2016 prepare a Consolidated Balance Sheet:

Balance Sheets of H. Ltd. and S. Ltd. as at 31st March, 2016

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		5,00,000	2,00,000
(b) Reserves and Surplus : General Reserve		80,000	60,000
Profit and Loss Account		90,000	70,000
(2) Share Application Money Pending Allotment :		—	—

(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		50,000	40,000
(b) Other Current Liabilities — Outstanding Expenses		20,000	10,000
TOTAL		7,40,000	3,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Machinery		3,00,000	1,50,000
(ii) Intangible Assets — Goodwill		30,000	10,000
(b) Non-current Investments — 16,000 Shares in S. Ltd.		1,90,000	—
(2) Current Assets :			
(a) Inventories		80,000	50,000
(b) Trade Receivables — Debtors		1,20,000	1,60,000
(c) Cash and Cash Equivalents — Cash at Bank		20,000	10,000
TOTAL		7,40,000	3,80,000

When control was acquired, S Ltd. had ₹ 40,000 in General Reserve and ₹ 30,000 in Profit and Loss Account. Immediately on purchase of shares H Ltd. received ₹ 16,000 dividend from S Ltd.
Debtors of H Ltd. include ₹ 20,000 due from S Ltd. whereas creditors of S Ltd. include ₹ 15,000 due to H Ltd. difference being accounted for by a cheque in transit.

9. The following are the summarised Balance Sheets of X Ltd. and its subsidiary Y Ltd. as at 31st December, 2015.

Balance Sheets of X Ltd. and Y Ltd. as at 31st December, 2015

Particulars	Note No.	X Ltd. (₹)	Y Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		1,00,000	50,000
(b) Reserves and Surplus : General Reserve		50,000	25,000
Profit and Loss Account		—	25,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 6% Debentures of ₹ 100 each		20,000	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		60,000	10,000
TOTAL		2,30,000	1,10,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		50,000	30,000
Plant and Machinery		40,000	—
Furniture and Fixtures		20,000	15,000
(b) Non-current Investments — 4,000 Equity Shares in Y Ltd.		50,000	—
(2) Current Assets :			
(a) Inventories		20,000	30,000
(b) Trade Receivables — Sundry Debtors		5,000	10,000
(c) Cash and Cash Equivalents — Cash in Hand		5,000	5,000
Cash at Hand		40,000	20,000
TOTAL		2,30,000	1,10,000

The following information are supplied :

(1) X Ltd. acquired shares in Y Ltd. on 1st January, 2015 when Y Ltd. had ₹ 25,000 in General Reserve and ₹ 20,000 in Profit and Loss Account (Cr. balance).

(2) Inventories of Y Ltd. includes goods of the value of ₹ 20,000 purchased from X Ltd. on which X Ltd. charged cost plus 25%.

(3) Debtors of Y Ltd. include ₹ 2,000 due from X Ltd.

(4) The proper value of land and buildings which stood at ₹ 30,000 in the books of Y Ltd. as at the date of acquisition was ₹ 50,000.

10. The following are the summarised Balance Sheets of H Ltd. and its subsidiary S Ltd. as at 30th November, 2016 :

Balance Sheets of H. Ltd. and S. Ltd. as at 30th November, 2016

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		4,00,000	1,50,000
(b) Reserves and Surplus : General Reserve		2,10,000	13,000
Profit and Loss Account		1,50,000	80,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		40,000	59,450
TOTAL		8,00,000	3,02,450
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Freehold Premises		2,20,000	89,000
Plant and Machinery		1,15,000	38,000
Furniture and Fixtures		61,000	18,000
(b) Non-current Investments — 10,000 Equity Shares in S. Ltd.		1,80,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,02,000	62,050
(c) Trade Receivables — Sundry Debtors		97,000	82,200
(d) Cash and Cash Equivalents — Cash at Bank		25,000	13,200
TOTAL		8,00,000	3,02,450

You are to prepare a Consolidated Balance Sheet as at 30.11.2016 showing in detail the necessary adjustments and taking into consideration the following information :

(a) H Ltd. acquired shares of S Ltd. on 1.12.2015 when the balances on their Profit and Loss Account and General Reserve were ₹ 66,000 and ₹ 9,000 respectively.

(b) Sundry creditors of ₹ 40,000 in the books of H Ltd. on 30.11.2016 included a sum of ₹ 24,000 payable to S Ltd. for credit purchases on which the latter company made a profit of ₹ 6,000 in 2015-16.

(c) S Ltd. declared and paid interim dividend @ 8% on 2.6.2016.

(d) Stock of ₹ 1,02,000 of H Ltd. on 30.11.2016 included unsold goods purchased from S Ltd. at a cost of ₹ 18,000.

11. H Ltd. acquired 4,000 Equity Shares of S Ltd. on 1.1.2015. Their Balance Sheets as at 31.12.2015 were as follows :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 50,000 Equity Share of ₹ 10 each fully paid		5,00,000	—
5,000 Equity Shares of ₹ 10 each fully paid		—	50,000
(b) Reserves and Surplus : General Reserve (1.1.2015)		1,00,000	20,000
Profit and Loss Account		1,00,000	25,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		50,000	5,000
TOTAL		7,50,000	1,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Plant		2,90,000	40,000
Furniture		1,50,000	9,000
(b) Non-current Investments — 4,000 Equity Shares in S. Ltd.		60,000	—
(2) Current Assets :			
(a) Inventories		1,20,000	30,000
(b) Trade Receivables		70,000	15,000
(c) Cash and Cash Equivalents — Cash at Bank		60,000	6,000
TOTAL		7,50,000	1,00,000

On 1.1.2015, the Profit and Loss Account of S Ltd. showed a credit balance of ₹ 10,000. On the same date, the Plant and Furniture of S Ltd. were re-valued at ₹ 60,000 and ₹ 8,000 respectively. These were not incorporated in the books. Depreciation is charged on Plant @ 20% p.a. and on Furniture @ 10% p.a. (assume no addition to nor any disposal from Plant and Furniture was made during the current year).
Prepare a Consolidated Balance Sheet as at 31.12.2015.

12. H Ltd. acquired 6,000 Equity Shares of S Ltd. of the face value of ₹ 10 each at a price of ₹ 85,000 on 1.4.2015. The Balance Sheet of the two companies as at 31.3.2016 were as follows :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st March, 2016

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		5,00,000	1,00,000
(b) Reserves and Surplus : General Reserve (1.4.2015)		2,10,000	50,000
Profit and Loss Account (1.4.2015)		45,000	20,000
Profit for the year (2015-16)		85,000	22,500
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		1,20,000	46,000
Bills Payable		40,000	30,000
TOTAL		10,00,000	2,68,500

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		2,00,000	50,000
Plant and Machinery		2,50,000	50,000
(ii) Intangible Assets — Goodwill		1,50,000	35,000
(b) Non-current Investments — 6,000 Equity Shares in S. Ltd.		1,00,000	—
(2) Current Assets :			
(a) Inventories		1,00,000	20,250
(b) Trade Receivables — Debtors		1,50,000	67,250
(c) Cash and Cash Equivalents —			
Bills Receivables		10,000	15,000
Cash at Bank		40,000	31,000
TOTAL		10,00,000	2,68,500

Out of the Debtors and Bills Receivable of H Ltd. ₹ 25,000 and ₹ 8,000 respectively represented those due from S Ltd. The stock in the hands of S Ltd. includes goods purchased from H Ltd. at ₹ 10,000 which includes profits charged by H Ltd. at 25% on cost. Both the companies have proposed 10% dividend for 2015-16.

You are required to prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31.3.2016.

13. The Balance Sheet of H Ltd. and S Ltd. as at 31.12.2015 were as follows :

Balance Sheets of H.Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital —			
50,000 Equity Shares of ₹ 10 each fully paid		5,00,000	—
20,000 Equity Shares of ₹ 10 each fully paid		—	2,00,000
(b) Reserves and Surplus		—	—
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		1,00,000	40,000
Bills Payable		50,000	30,000
(b) Current Account — S. Ltd.		10,000	—
TOTAL		6,60,000	2,70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		3,50,000	1,45,000
(b) Non-current Investments — 15,000 Equity Shares in S. Ltd.		1,50,000	—
(2) Current Assets :			
(a) Trade Receivables — Debtors		1,00,000	80,000
Bills Receivables		40,000	20,000
(b) Cash and Cash Equivalents — Cash at Bank		20,000	10,000
(c) Other Current Assets — Current Account : H. Ltd.		—	15,000
TOTAL		6,60,000	2,70,000
Contingent Liabilities for Bills Discounted		4,000	6,000

Additional information :

(a) Sundry Creditors of S Ltd. include ₹ 10,000 due to H Ltd.

(b) Bills Receivable of H Ltd. include ₹ 8,000 accepted by S Ltd.

(c) Bills Receivable of S Ltd. include ₹ 10,000 accepted by H Ltd.

(d) The difference in Current Accounts of the companies is due to the fact that a cheque for ₹ 5,000 was sent by H Ltd. but not reached S Ltd. yet.

(e) Contingent liability of ₹ 4,000 for bills discounted as shown in the Balance Sheet of H Ltd. relates to a bill accepted by S Ltd.

Prepare a Consolidated Balance Sheet as at 31.12.2015.

14. The Balance Sheet of H Ltd. and S Ltd. as at 31st December, 2015 are as follows :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		4,00,000	2,00,000
(b) Reserves and Surplus : General Reserve		36,000	40,000
Profit and Loss Account (1.1.2015)		34,000	32,000
Profit for the year 2015		15,000	14,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Creditors		60,000	30,400
TOTAL		5,45,000	3,16,400
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		2,65,000	2,76,400
(ii) Intangible Assets — Goodwill		—	40,000
(b) Non-current Investments — 18,000 Equity Shares in S. Ltd.		2,80,000	—
(2) Current Assets :		—	—
TOTAL		5,45,000	3,16,400

In the case of S Ltd., the profit for the year is ₹ 24,000 before transfer of ₹ 10,000 to General Reserve. H Ltd. acquired 90% of the shares in S Ltd. on 31st December 2014. ₹ 36,000 of the sundry assets of H Ltd. and ₹ 12,400 of S Ltd. are to be written-off out of current year's profits. Prepare a Consolidated Balance Sheet as at 31st December, 2015.

15. X Ltd. acquired 80% of the Equity Shares of ₹ 100 each in Y Ltd. on 31st December, 2015. Given are the summarised balances of X Ltd. and Y Ltd. as on that date :

Balance Sheets of X Ltd. and Y Ltd. as at 31st December, 2015

Particulars	Note No.	X Ltd. (₹)	Y Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 5,000 Equity Share of ₹ 100 each fully paid		5,00,000	—
3,000 Equity Shares of ₹ 100 each fully paid		—	3,00,000
(b) Reserves and Surplus : Capital Reserve		—	1,00,000
General Reserve		80,000	1,00,000
Profit and Loss Account		60,000	80,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Loan from X Ltd.		—	50,000

(4) Current Liabilities :			
Trade Payables — Creditors		75,000	25,000
Bills Payable (including ₹ 3,000 in favour of X Ltd.)		—	5,000
TOTAL		7,15,000	6,60,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		2,00,000	2,50,000
(b) Non-current Investments — 2,400 Equity Shares in Y Ltd.		3,00,000	—
(c) Loan to Y Ltd.		47,000	—
(2) Current Assets :			
(a) Current Investments			
(b) Inventories		75,000	90,000
(c) Trade Receivables — Sundry Debtors		50,000	1,95,000
Bills Receivable (including 2,000 from Y Ltd)		4,000	—
(d) Cash and Cash Equivalents — Cash at Bank		39,000	1,25,000
TOTAL		7,15,000	6,60,000

You are given the following information :

(1) Y Ltd. made a bonus issue on 31st December, 2015 of one Equity Share for every three held by reducing its Capital Reserve. The above Balance Sheet does not reflect the transaction.

(2) The fixed assets of Y Ltd. were undervalued and should be written-up by ₹ 20,000 on 31st December, 2015.

(3) The difference in the figures on the loan accounts of X Ltd. and Y Ltd. is due to interest thereon not yet credited in the accounts of X Ltd.

You are required to prepare a Consolidated Balance Sheet of X Ltd. and subsidiary Y Ltd. as at 31st December, 2015.

16. A Ltd. acquired 1,600 Equity Shares of ₹ 100 each in B Ltd. on 31.12.2015. The summarised Balance Sheets of A Ltd. and B Ltd. as on that date were as under :

Balance Sheets of A Ltd. and B Ltd. as at 31st December, 2015

Particulars	Note No.	A Ltd. (₹)	B Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 5,000 Equity Share of ₹ 100 each fully paid		5,00,000	—
2,000 Equity Shares of ₹ 100 each fully paid		—	2,00,000
(b) Reserves and Surplus : Capital Reserve		—	1,20,000
General Reserve		2,40,000	—
Profit and Loss Account		57,200	36,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings — Loan from Bank		80,000	—
(b) Trade Payables — Sundry Creditors		47,100	9,000
Bills Payable (including ₹ 4,000 to A Ltd.)		—	8,400
TOTAL		9,24,300	3,73,400
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		1,50,000	1,80,000
Plant and Machinery		2,40,000	1,09,400
(b) Non-current Investments — 1,600 Equity Shares in B Ltd. at cost		3,40,000	—

(2) Current Assets :			
(a) Current Investments			
(b) Inventories		1,20,000	36,000
(c) Trade Receivables — Debtors		44,000	40,000
Bills Receivable (including 3,000 from B Ltd.)		15,800	—
(d) Cash and Cash Equivalents — Cash at Bank		14,500	8,000
TOTAL		9,24,300	3,73,400

You are also supplied the following information :

(i) B Ltd. had made a bonus issue on 31.12.2015, of one Equity Share for every two shares held by its shareholders. Effect has yet to be given in the accounts for this issue.

(ii) The Directors are advised that Land and Building of B Ltd. are undervalued by ₹ 20,000 and the Plant and Machinery of B Ltd. overvalued by ₹ 10,000. Value of these assets have to be adjusted accordingly.

(iii) Sundry Creditors of A Ltd. include ₹ 12,000 due to B Ltd.

You are required to prepare the Consolidated Balance Sheet as at 31.12.2015.

17. M Ltd. acquired all the shares of N Ltd. as on 1st January, 2015 for a price of ₹ 7,35,000. The following are the summarised Balance Sheets on 31st December, 2015 :

Balance Sheets of M Ltd. and N Ltd. as at 31st December, 2015

Particulars	Note No.	M. Ltd. (₹)	N. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 50 each fully paid		11,25,000	—
Equity Share of ₹ 5 each fully paid		—	3,75,000
(b) Reserves and Surplus : General Reserve		6,00,000	22,500
Profit and Loss Account		5,25,000	2,47,500
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		1,20,000	1,05,000
TOTAL		23,70,000	7,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		—	1,95,000
Plant and Machinery		7,50,000	2,25,000
(b) Non-current Investments — 75,000 Equity Shares in N. Ltd.		7,35,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		2,40,000	1,35,000
(c) Trade Receivables		1,95,000	1,05,000
(d) Cash and Cash Equivalents — Cash at Bank		4,50,000	90,000
TOTAL		23,70,000	7,50,000

The balance in the Profit and Loss Account of N Ltd. as on 1st January, 2015 was ₹ 1,50,000, a dividend of 10% having been paid during the year in respect of 2014. Plant is to be revalued at ₹ 2,40,000 on 1st January, 2015. Depreciation at 10% has been charged in 2015. The balance in the General Reserve on 1st January, 2015 was ₹ 22,500.

Creditors of M Ltd. include ₹ 45,000 for purchases from N Ltd. on which the latter Company made a profit of ₹ 12,750. Stock of M Ltd. includes ₹ 15,000 at cost purchased from N Ltd. as part of ₹ 45,000 purchases. Profit and Loss Account of M Ltd. include dividend received from subsidiary. Prepare a Consolidated Balance Sheet.

18. Strong Ltd. acquired 3,200 Equity Shares of Weak Ltd. on December 31, 2015. The summarised Balance Sheet of the two companies as on the date are given below :

Balance Sheets of Strong Ltd. and Weak ltd. as at 31st December, 2015

Particulars	Note No.	Strong Ltd. (₹)	Weak Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		10,00,000	4,00,000
(b) Reserves and Surplus : General Reserve		4,80,000	3,40,000
Profit and Loss Account		1,14,400	72,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Bank Loan		1,60,000	—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		94,400	18,000
Bills Payable (including ₹ 6,000 to Strong Ltd.)		—	16,800
TOTAL		18,48,800	8,46,800
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		3,00,000	3,60,000
Plant and Machinery		4,80,000	3,18,800
(b) Non-current Investments — 3,200 Equity Shares in Weak ltd, at cost		6,80,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		2,40,000	72,000
(c) Trade Receivables — Sundry Debtors		88,000	80,000
Bills Receivable (including ₹ 6,000 from Weak ltd.)		31,600	—
(d) Cash and Cash Equivalents — Cash at Bank		29,200	16,000
TOTAL		18,48,800	8,46,800

You are supplied with the following information :

(a) Weak Ltd. made a bonus issue on December 31, 2015, of one Equity Share for every four shares by its shareholders. This has not yet been accounted for.

(b) Sundry creditors of Strong Ltd. included ₹ 24,000 due to Weak Ltd.

(c) The directors have decided to revalue the land and buildings and plant and machinery of Weak Ltd. at ₹ 4,00,000 and ₹ 2,98,800 respectively.

Prepare the Consolidated Balance Sheet as on December 31, 2015 with workings.

19. The following are the Balance Sheets of a holding company and subsidiary company as on December 31, 2014 and 2015:

Balance Sheet of Holding Company as at 31st December, 2014 and 2015

Particulars	Note No.	2014 (₹)	2015 ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 35,000 Equity Shares of ₹ 10 each fully paid		3,50,000	3,50,000
(b) Reserves and Surplus : General Reserve		41,000	57,000
Profit and Loss Account		67,000	80,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		39,000	35,000
TOTAL		4,97,000	5,22,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings at Cost		1,10,000	1,10,000
Machinery less Depreciation		80,000	75,000
(ii) Intangible Assets — Goodwill		50,000	50,000
(b) Non-current Investments — 9,000 Equity Shares in Subsidiary at cost		1,50,000	1,50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		40,000	47,000
(c) Trade Receivables		55,000	60,000
(d) Cash and Cash Equivalents — Cash at Bank		12,000	30,000
TOTAL		4,97,000	5,22,000

Balance Sheet of Subsidiary Company as at 31st December, 2014 and 2015

Particulars	Note No.	2014 (₹)	2015 ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — 10,000 Equity Shares of ₹ 10 each		1,00,000	1,00,000
(b) Reserves and Surplus : General Reserve		17,500	20,500
Profit and Loss Account		12,000	28,500
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		10,000	8,000
TOTAL		1,39,500	1,57,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Machinery less Depreciation		45,000	42,500
(ii) Intangible Assets — Goodwill		40,000	40,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		25,000	30,000
(c) Trade Receivables — Sundry Debtors		22,000	32,000
(d) Cash and Cash Equivalents — Cash at Bank		7,500	12,500
TOTAL		1,39,500	1,57,000

The shares in the subsidiary company were acquired on December 31, 2014. No dividend has been declared. Prepare the Consolidated Balance Sheet as on December 31, 2015.

20. The Balance Sheets of X Ltd. and Y Ltd. as at 31st December, 2015 of X Ltd. are given below :

Balance Sheets of X Ltd. and Y Ltd. as at 31st December, 2015

Particulars	Note No.	X Ltd. (₹)	Y Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		6,00,000	1,60,000
6% Preference Share of ₹ 10 each fully paid		4,00,000	80,000
(b) Reserves and Surplus : General Reserve		1,00,000	40,000
Profit and Loss Account		60,000	24,000
(2) Share Application Money Pending Allotment :		—	—

(3) Non-current Liabilities :			
(a) Long-term Borrowings — 5% Debentures		—	1,00,000
(4) Current Liabilities :			
(a) Other Current Liabilities		3,00,000	1,50,000
TOTAL		14,60,000	5,54,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		7,00,000	1,50,000
(ii) Intangible Assets — Goodwill at Cost		1,50,000	1,00,000
(b) Non-current Investments :			
12,000 Equity Shares in Y Ltd.		1,30,000	—
5,000, 6% Preference Shares in Y Ltd.		60,000	—
(2) Current Assets :			
(a) Other Current Assets		4,20,000	3,04,000
TOTAL		14,60,000	5,54,000

At the date of acquisition of the shares in Y Ltd. by X Ltd. the General Reserve and Profit and Loss Account of Y Ltd. stood at ₹ 30,000 and ₹ 10,000 respectively. Y Ltd. paid preference dividends up to 30th June, 2015 and equity dividends up to 31st December, 2014. The equity dividend of ₹ 6,000 received by X Ltd., since the acquisition of the shares out of the balance of ₹ 10,000 brought forward at the time of acquisition has been credited to the Investment Account by X Ltd. Debenture interest has been paid up to 31st December, 2015.

It was decided that the value of the plant and machinery of Y Ltd,. standing in the books at ₹ 50,000 should be revalued at ₹ 40,000. No adjustment has been made for this in the books. Depreciation of plant and machinery is written-off at 20% p.a.

The stock of X Ltd. includes goods worth ₹ 7,500 purchased from Y Ltd. the cost of which to Y Ltd. is ₹ 5,000. The stock of Y Ltd. includes goods worth ₹ 20,000 purchased from X Ltd. X Ltd. invoices its goods by adding 25% to cost.

You are required to prepare a Consolidated Balance Sheet of X Ltd. and its subsidiary as at 31st December, 2015.

21. Following are the Balance Sheets of A Ltd. and its subsidiary B Ltd. :

Balance Sheets of A Ltd. and B Ltd. as at ...

Particulars	Note No.	A Ltd. (₹)	B Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		1,10,000	40,000
(b) Reserves and Surplus : Securities Premium on 2,600 Shares		13,000	—
General Reserve		—	10,000
Profit and Loss Account		14,000	3,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		9,500	15,000
TOTAL		1,46,500	68,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		17,500	12,500
Plant and Machinery		35,000	19,500
Furniture		6,000	2,500
(b) Non-current Investments — 3,600 Equity Shares in B Ltd. at cost		39,000	—

(2) Current Assets :			
(a) Current Investments			
(b) Inventories		20,000	13,500
(c) Trade Receivables — Sundry Debtors		25,000	15,500
(d) Cash and Cash Equivalents — Cash at Bank		500	4,500
(e) Due from B Ltd.		3,500	—
TOTAL		1,46,500	68,000

You are required to prepare a Consolidated Balance Sheet together with work sheet, having regard to the following:

(i) On the date when A acquired the shares of B Ltd. the latter had a reserve of ₹ 2,500 and a credit balance on Profit and Loss Account of ₹ 500.

(ii) In determining the value of shares of B Ltd., plant and machinery, which then stood in the books at ₹ 22,500 was revalued at ₹ 27,000 and furniture, etc., standing in the books at ₹ 3,000 was revalued at ₹ 1,800. The new values were not incorporated in the books.

(iii) B Ltd. has purchased goods from A Ltd. of which ₹ 7,000 are still in stock. A Ltd. sells to B Ltd. at cost plus 25%.

22. From the following Balance Sheets, make out the Consolidated Balance Sheet of the group as at 31.12.2015:

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		4,00,00	5,00,000
(b) Reserves and Surplus : Profit and Loss Account		1,60,000	1,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		50,000	90,000
Bills Payable		10,000	15,000
TOTAL		6,20,000	7,05,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		—	3,00,000
(b) Non-current Investments — Shares in S Ltd.		4,50,000	—
(2) Current Assets :			
(a) Trade Receivables — Bills Receivable		10,000	8,000
(b) Cash and Cash Equivalents — Cash in Hand		10,000	20,000
(c) Other Current Assets		1,50,000	3,77,000
TOTAL		6,20,000	7,05,000

Additional information :

(1) Net profit for 2015 (included above) : H Ltd. ₹ 40,000; S Ltd. ₹ 80,000.

(2) In 2015, S Ltd. credited ₹ 4,000 to Profit and Loss Account in settlement of claim for loss of stock (cost ₹ 5,000, included in the opening stock of the year) by fire on 31.3.2015.

(3) The following points were not considered in making out the accounts :

  (a) ₹ 500 p.m. expenses were incurred by H Ltd. on behalf of S Ltd. It was by mistake debited to Profit and Loss Account of H Ltd. and nothing has been done in the accounts of S Ltd.

  (b) Dividend proposed for 2015 — 10%.

(4) On 30.4.2015, H Ltd. acquired 32,000 shares at ₹ 4,50,000. On the same day, bonus shares @ one for every four held were received; 10% dividend has also been received on the same day from S Ltd. The dividend have been credited to Profit and Loss Account.

(5) Bills Receivable of H Ltd. include ₹ 5,000 accepted by S Ltd., ₹ 3,000 of which is discounted.

(6) Sundry Creditors of S Ltd. include ₹ 10,000 due to H Ltd. whereas Sundry Debtors of H Ltd. include ₹ 12,000 due from S Ltd., the difference being represented by a cheque-in-transit.

23. From the following Balance Sheets of H Ltd. and its subsidiary S Ltd. as at 31.12.2015 prepare a Consolidated Balance Sheet :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		2,00,000	40,000
6% Preference Share of ₹ 100 each fully paid		1,50,000	80,000
(b) Reserves and Surplus : General Reserve		50,000	20,000
Profit and Loss Account		23,000	11,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-trerm Borrowings — 5% Debentures		—	50,000
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		92,000	60,000
Due to S Ltd.		3,000	—
Bills Payable — Drawn by H. Ltd.		—	10,000
Others		25,000	5,000
TOTAL		5,43,000	2,76,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Buildings less Depreciation		1,00,000	50,000
Plant and Machinery less Depreciation		1,20,000	30,000
Furniture and Fittings less Depreciation		12,000	5,000
(ii) Intangible Assets — Goodwill at Cost		60,000	40,000
(b) Non-current Investments — 3,000 Equity Shares of S Ltd.		33,000	—
200 Preference Shares of S. Ltd.		24,000	—
(2) Current Assets :			
(a) Inventories		80,000	70,000
(b) Trade Receivables — Sundry Debtors		70,000	46,000
Bills Receivables :			
S Ltd.		3,000	—
Others		11,000	7,000
Amount Due from H. Ltd.		—	5,000
(c) Cash and Cash Equivalents — Cash at Bank		30,000	2,30,000
TOTAL		5,43,000	2,76,000

On the date when H Ltd. acquired shares in S Ltd. latter's reserve stood at ₹ 15,000 and its Profit and Loss Account had a credit balance of ₹ 8,000. Preference dividends have been regularly paid upto 30.6.2015, and equity dividends upto 31.12.2014.

Dividend received by H Ltd. have been correctly recorded in that company's books. Of the first dividend on Equity Shares paid since the date of acquisition of the shares. H Ltd. credited ₹ 3,000 to the Equity Shares in S Ltd. Account. Debenture interest are paid to date.

At the date of acquisition of the shares, plant and machinery standing at ₹ 24,000 in S Ltd.'s books were revalued at ₹ 20,000 but no adjustment was made in the books. Between that date and 31.12.2015, depreciation amounting to 40% in all have been written-off from plant. H Ltd. remitted ₹ 2,000 on 30.12.2015 but was received by S Ltd. on 4.1.2016.

24. The following are the summarised Balance Sheets of H Ltd. and S Ltd. as on March 31, 2016 :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st March, 2016

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		6,00,000	2,00,000
7% Preference Shares of ₹ 100 each fully paid		—	1,60,000
(b) Reserves and Surplus : General Reserve		1,00,000	80,000
Profit and Loss Account		1,97,000	88,800
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 5% Debentures		—	40,000
(4) Current Liabilities :			
(a) Trade Payables — Creditors		2,94,000	1,24,400
(b) Short-term Provisions : Proposed Dividend —			
on Equity Shares		60,000	20,000
on Preference Shares		—	11,200
(c) Other Current Liabilities — Debenture Interest Accrued		—	2,400
TOTAL		12,51,000	7,26,800
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		5,00,000	4,40,000
(b) Non-current Investments — 15,000 Equity Shares of S Ltd.		3,30,000	—
1,200 Preference Shares of S. Ltd. at cost		1,20,000	—
6% Debentures (Face value ₹ 10,000)		10,000	—
(2) Current Assets :			
(d) Other Current Assets		2,91,000	2,86,800
TOTAL		12,51,000	7,26,800

The following particulars are available :

(a) The General Reserve of S Ltd. as on 31.3.2015 was ₹ 80,000.

(b) H Ltd. acquired the shares cum-dividend in S Ltd. on 31.3.2015.

(c) The balance of the Profit and Loss Account of S Ltd. is made up as follows :

Balance as on 31.3.2015	₹ 56,000
Net Profit (31.3.2016)	₹ 64,000
	₹ 1,20,000
Less : Provision for proposed dividends	₹ 31,200
	₹ 88,800

(d) The balance of Profit and Loss Account of S Ltd. as on March 31, 2015 is after providing for the preference dividend of ₹ 11,200 and proposed equity dividend of ₹ 10,000 both of which were subsequently paid but credited to Profit and Loss Account of H Ltd.

(e) No entries have been made in the books of H Ltd. for debenture interest due from or proposed dividend of S Ltd. for the year ending March 31, 2016.

(f) S Ltd. has issued fully paid bonus shares of ₹ 40,000 on March 31, 2016, among the existing shareholders by drawing upon the General Reserve. The transaction has not been given effect to in the books of S Ltd.

You are required to prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary company S Ltd. as on March 31, 2016.

Mid-year Purchase

25. H Ltd. acquired 8,000 Equity Shares of S Ltd. on 30.6.2015. Their Balance Sheets as at 31.12.2015 stood as follows:

Balance Sheets of H. Ltd. and S/ Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital —			
20,000 Equity Shares of ₹ 10 each fully paid		2,00,000	—
10,000 Equity Shares of ₹ 10 each fully paid		—	1,00,000
(b) Reserves and Surplus : General Reserve		50,000	30,000
Profit and Loss Account		20,000	10,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		30,000	10,000
TOTAL		3,00,000	1,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		1,20,000	1,00,000
(b) Non-current Investments — 8,000 Equity Shares of S. Ltd. @ ₹ 12 each		96,000	—
(2) Current Assets :			
(a) Other Current Assets		84,000	50,000
TOTAL		3,00,000	1,50,000

On 1.1.2015, the Profit and Loss Account and the General Reserve of S Ltd. showed the credit balance of ₹ 6,000 and ₹ 20,000 respectively. Prepare a Consolidated Balance Sheet as at 31.12.2015 assuming that the profits of S Ltd. accrued evenly throughout the year.

26. The following are the Balance Sheets of H Ltd. and S Ltd. as at 31st December, 2015 :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		2,00,000	50,000
(b) Reserves and Surplus : General Reserve		50,000	20,000
Profit and Loss Account (1.1.2015)		30,000	7,500
Profit for the year (2015)		50,000	20,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Other Current Liabilities		20,000	10,000
TOTAL		3,50,000	1,07,500
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		1,95,000	70,000
(b) Non-current Investments — 4,000 Shares in S. Ltd. at cost		60,000	—
(2) Current Assets :			
(a) Other Current Assets		95,000	37,500
TOTAL		3,50,000	1,07,500

(i) H Ltd. purchased on 1st July, 2015, 4,000 shares in S Ltd. at ₹ 15 each.

(ii) Stock of S Ltd. includes ₹ 7,500 worth of goods purchased from H Ltd., which company sells goods at 25% above cost.

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st December, 2015.

27. You are given the following Balance Sheets of H Ltd. and S Ltd. as on December 31, 2015 :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		5,00,000	2,00,000
(b) Reserves and Surplus : General Reserve (1.1.2015)		1,00,000	60,000
Profit and Loss Account		1,40,000	90,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Creditors		80,000	50,000
Bills Payable		—	40,000
TOTAL		8,20,000	4,40,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Buildings		2,00,000	1,30,000
Plant and Machinery		1,60,000	90,000
(ii) Intangible Assets — Goodwill		40,000	30,000
(b) Non-current Investments — 1,500 Equity Shares in S. Ltd. at cost		2,40,000	—
(2) Current Assets :			
(a) Inventories		1,00,000	90,000
(b) Trade Receivablesm — Debtors		20,000	75,000
(c) Cash and Cash Equivalents — Cash at Bank		60,000	25,000
TOTAL		8,20,000	4,40,000

The Profit and Loss Account of S Ltd. showed a credit balance of ₹ 50,000 on January 1, 2015. A dividend of 15% was paid in October 2015, for the year 2014. This dividend was credited to the Profit and Loss Account of H Ltd. H Ltd. acquired the shares in S Ltd. on July 1, 2015. The bills payable of S Ltd. were all issued in favour of H Ltd. which had got the bills discounted.

Included in the creditors of S Ltd. is ₹ 20,000 for goods supplied by H Ltd. Included in the stock of S Ltd. are goods of the value of ₹ 8,000 which were supplied by H Ltd. at a profit of $33^{1}/_{3}$% on cost. In arriving at the value of S Ltd. shares, the plant and machinery which then stood in the books at ₹ 1,00,000 was revalued at ₹ 1,50,000. The new value was not incorporated in the books. No change in these assets have been made. Prepare Consolidated Balance Sheet as on December 31, 2015. Show details of workings.

28. H Ltd purchased 13,500 shares of S Ltd on 01.07.2012 at a cost of ₹ 2,10,000. Following are the Balance Sheets of two companies as at 31.03.2017 :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st March, 2017

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		3,60,000	1,80,000
(b) Reserves and Surplus : General Reserve		36,000	30,000
Profit and Loss Account		60,000	60,000

(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Trade Payables — Creditors		60,000	42,000
Bills Payable to H. Ltd.		—	6,000
(b) Short-term Provision — Proposed Dividend		27,000	18,000
TOTAL		5,43,000	3,36,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		60,000	60,000
Plant and Machinery		1,20,000	1,08,000
(b) Non-current Investments — 13,500 Equity Shares of S. Ltd. at cost		2,10,000	—
Others		20,000	52,000
(2) Current Assets :			
(a) Inventories		60,000	60,000
(b) Trade Receivables — Debtors		53,000	44,000
(c) Cash and Cash Equivalents — Cash at Bank		20,000	12,000
TOTAL		5,43,000	3,36,000

Other information :

(a) S Ltd had on 1.4.2016 ₹ 18,000 in General Reserve and ₹ 36,000 (Cr.) in Profit and Loss Account.

(b) In September 2016, S Ltd paid a dividend for the year 2015-16. H Ltd received ₹ 15,000 of such dividend and credited the same to its Investment Account.

(c) Plant and Machinery standing in the books of S Ltd at ₹ 1,20,000 on 01.04.2016 was revalued at ₹ 1,40,000 on the date of acquisition of shares. No addition or sale of machinery was made during the year.

(d) Stock of S Ltd included ₹ 9,600 purchased from H Ltd on which H Ltd made a profit of 20% on cost.

Prepare Consolidated Balance Sheet of H Ltd with its subsidiary S Ltd as on 31.03.2017.

29. The following Balance Sheets are presented to you (31.12.2015) :

Balance Sheets of H. Ltd. and S. Ltd. as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		5,00,000	2,00,000
(b) Reserves and Surplus : General Reserve		1,00,000	—
Profit and Loss Account		80,000	(1,00,000)
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 6% Debentures		—	1,00,000
(4) Current Liabilities :			
Trade Payables — Trade Creditors		75,000	45,000
TOTAL		7,55,000	2,45,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		3,50,000	1,50,000
(b) Non-current Investments — 1,500 Shares in S. Ltd. @ ₹ 80 each		1,20,000	—
6% Debentures in S. Ltd. (Acquired at par)		60,000	—

(2) Current Assets :			
(a) Inventories		90,000	40,000
(b) Trade Receivables — Debtors		60,000	30,000
(c) Cash and Cash Equivalents — Cash at Bank		75,000	25,000
TOTAL		7,55,000	2,45,000

H Ltd. acquired the shares on May 1, 2015. The Profit and Loss Account of S Ltd. showed a debit balance of ₹ 1,50,000 on January 1, 2015. During March 2015, goods costing ₹ 6,000 were destroyed by fire and the insurers paid only ₹ 2,000. Trade creditors of S Ltd. include ₹ 20,000 for goods supplied by H Ltd. on which the latter company made a profit of ₹ 2,000. Half of the goods were still in stock. Prepare the Consolidated Balance Sheet.

30. The following are the Balance Sheets of H Ltd. and its subsidiary S Ltd. as at 31st December, 2015 :

Balance Sheets of and as at 31st December, 2015

Particulars	Note No.	H. Ltd. (₹)	S. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		10,00,000	4,00,000
(b) Reserves and Surplus : General Reserve		2,00,000	—
Profit and Loss Account		1,90,000	(2,00,000)
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 6% Debentures		—	2,00,000
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		1,20,000	90,000
TOTAL		15,10,000	4,90,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets			
(b) Non-current Investments — 3,000 Equity Shares in S. Ltd. at cost		2,40,000	—
Debentures in S. Ltd. at par		1,20,000	—
(2) Current Assets :			
(a) Inventories		1,80,000	80,000
(b) Trade Receivables		1,20,000	60,000
(c) Cash and Cash Equivalents — Cash at Bank		1,50,000	50,000
TOTAL		15,10,000	4,90,000

H Ltd. acquired the shares in S Ltd. on 1st April, 2015. The Profit and Loss Account of S Ltd. showed a debit balance of ₹ 3,00,000 on 1st January 2015. Creditors of Y Ltd. include ₹ 40,000 for goods supplied by H Ltd. on which H Ltd. made a profit of ₹ 4,000. Half of the goods were still in stock on 31st December, 2015.

Prepare a Consolidated Balance Sheet as at 31st December, 2015.

31. Following are the Balance Sheets of M Ltd. and N Ltd. as at 31st December, 2015 :

Balance Sheets of M. Ltd. and N. Ltd. as at 31st December, 2015

Particulars	Note No.	M. Ltd. (₹)	N. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 100 each fully paid		10,00,000	4,00,000
(b) Reserves and Surplus : General Reserve (1.1.2015)		2,00,000	1,00,000
Profit and Loss Account		3,00,000	2,00,000

(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Other Current Liabilities		2,00,000	1,00,000
TOTAL		17,00,000	8,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		4,00,000	4,00,000
(ii) Intangible Assets — Goodwill		1,00,000	50,000
(b) Non-current Investments — 3,000 Equity Shares in N. Ltd.		5,00,000	—
(2) Current Assets :			
(a) Other Current Assets		7,00,000	3,50,000
TOTAL		17,00,000	8,00,000

M Ltd. acquired the share in N Ltd. on 1st July, 2015.

On 1st January, 2015, the Profit and Loss Account of N Ltd. showed a credit balance of ₹ 1,00,000 and a dividend of 10% was paid on 1st September, 2015 for the year 2014. This dividend was credited by M Ltd. to its Profit and Loss Account.

In arriving at the value of shares of N Ltd. plant and machinery of N Ltd. which then stood at ₹ 2,00,000 was revalued at ₹ 3,00,000. This value was not given effect to in the books. There was no change in these assets since that date. Fixed assets of N Ltd. include plant and machinery worth ₹ 1,80,000.

You are required to prepare a Consolidated Balance Sheet of M Ltd. and its subdiary as on 31st December, 2015.

32. On 1st January, 2013, A Ltd. acquired 8,000 shares of ₹ 10 each of B Ltd. at ₹ 90,000. The respective Balance Sheets as on 31st December, 2015 are given below :

Balance Sheets of A. Ltd. and B. Ltd. as at 31st December, 2015

Particulars	Note No.	A. Ltd. (₹)	B. Ltd. ₹
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		1,00,000	1,00,000
(b) Reserves and Surplus : General Reserve		40,000	26,000
Profit and Loss Account		36,000	35,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
Trade Payables — Sundry Creditors		71,000	48,000
TOTAL		2,47,000	2,09,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		60,000	1,10,000
(b) Non-current Investments — 8,000 Equity Shares in S. Ltd.		90,000	—
Others		10,000	15,000
(2) Current Assets :			
(a) Inventories		30,000	40,000
(b) Trade Receivables — Debtors		25,000	20,000
(c) Cash and Cash Equivalents — Cash at Bank		32,000	24,000
TOTAL		2,47,000	2,09,000

Additional information :

(i) At the time of acquiring shares, B Ltd. had ₹ 24,000 in reserve and ₹ 15,000 in Profit and Loss Account.

(ii) B Ltd. paid 10% dividend in 2013, 12% in 2014, 15% in 2015 for 2012, 2013 and 2014 respectively. All dividends received have been credited to the Profit and Loss Account of A Ltd.

(iii) Proposed dividend of both the companies for 2015 is 10%.

(iv) One bonus share for five fully paid shares held has been declared by B Ltd. out of pre-acquisition reserve on 31st December, 2015. No effect has been given to that in the above accounts.

(v) On 1st January 2013, building of B Ltd. which stood in the books at ₹ 50,000 was revalued at ₹ 60,000 but no adjustments has been made in the books. Depreciation has been charged @ 10% p.a. on reducing balance method.

(vi) In 2015, A Ltd. purchased from B Ltd. goods for ₹ 10,000 on which B Ltd. made a profit of 20% on sales, 25% of such goods are lying unsold on 31st December, 2015.

Prepare the Consolidated Balance Sheet as at 31st December, 2015.

Guide to Answers

Multiple Choice

1. A equity shares only; 2.B capital profit; 3. B profit and loss account of the holding company; 4. C as a separate item; 5. A in full, irrespective of percentage of holding

Practical Questions

No.	Capital Profit	Goodwill	Capital Reserve	Minority Interest	C.B.S. Total
1	24,00,000	—	7,20,000	4,00,000	3,18,40,000
2	60,000	55,000	—	1,20,000	15,75,000
3	35,000	—	8,000	28,000	5,60,000
4	10,000	—	2,500	35,000	6,20,000
5	1,30,000	—	4,000	1,34,000	14,94,500
6	34,000	—	500	33,500	4,59,000
7	2,00,000	—	43,333	2,00,000	21,98,000
8	70,000	—	26,000	66,000	9,15,000
9	65,000	—	42,000	24,000	3,03,200
10	75,000	30,000	—	81,000	9,22,450
11	38,000	—	10,400	20,240	7,96,200
12	70,000	—	17,000	73,000	11,48,500
13	Nil	Nil	Nil	50,000	7,42,000
14	62,000	84,200	—	27,360	5,77,200
15	2,00,000	—	1,80,000	1,20,000	10,46,000
16	1,20,000	47,200	—	73,200	9,99,900
17	1,25,000	1,97,500	—	Nil	25,24,250
18	3,32,000	14,400	—	1,66,400	20,20,000
19	29,500	1,23,450	—	14,900	5,62,450
20	9,500	2,62,875		81,800	18,12,375
21	6,300	—	2,670	5,590	1,73,500
22	46,000	—	18,800	1,09,200	8,63,000
23	15,000	—	4,250	76,550	7,53,600
24	1,36,000	62,100	—	1,40,000	15,79,900
25	33,000	—	10,400	28,000	3,54,000
26	37,500	—	10,000	19,500	3,96,000
27	1,70,000	10,000	—	1,00,563	9,89,750
28	71,000	6,750	—	72,875	7,10,650
29	(1,36,000)	72,000	—	25,000	8,70,750
30	2,75,000	1,46,250	—	50,000	17,44,750
31	3,30,000	72,500	—	1,97,500	20,12,000
32	19,000	—	29,200	33,658	3,72,790

13

Underwriting of Shares and Debentures

Introduction

Underwriting is an agreement, with or without conditions, to subscribe to the securities of an issuer when existing shareholders of the issuer or the public do not subscribe to the securities offered to them.

When an issuer goes in for an Initial Public Offer (IPO) or Further Public Offer (FPO), it may face certain uncertainty about whether its offer of shares or other securities will be subscribed in full or not. If the public issue does not get fully subscribed, the project for which the funds are being raised cannot be implemented. As per law, it is required that if the company is not able to collect 90% of the offer amount (minimum subscription), then it needs to compulsorily return the money to those who have subscribed to the shares.

To avoid the risk of under-subscription issuers may seek the help of a specialised group of risk-redeemers — called ***Underwriters.*** It is the business of the underwriter to handle IPO / FPO of different companies. They are aware of the market conditions. A company may go for IPO / FPO once or twice in its life time and that is why most of the issuers are going for underwriting. The function of the Underwriters is to arrange subscription of floated shares.

The underwriters, as risk-takers, are entitled to get commission at prescribed rates.

It can be easily comprehended that when the floated shares are likely to be under-subscribed, the underwriters come to the forefront. In other cases they remain in the background, acting as catalysts — arrangers of sale to the investing public.

Before entering into an agreement with the issuer, the underwriters assess the following :

(a) worth of the public issue;

(b) market response to the issue; and

(c) their own ability to get the issue fully subscribed.

Depending upon the risk assessment of the issue, the underwriters decide on their amount of commission. Owing to under-subscription, if the issue devolves upon them, the underwriters pay up the required amount and deduct their commission from that.

SEBI (ICDR) Regulations, 2009 Regarding Underwriting

Regulation 13 of the SEBI (ICDR) Regulation, 2009 states that :

(1) Where the issuer making a public issue (other than through the book building process) or rights issue, desires to have the issue underwritten, it shall appoint the underwriters in accordance with Securities and Exchange Board of India (Underwriters) Regulations, 1993.

(2) Where the issuer makes a public issue through the book building process, such issue shall be underwritten by book runners or syndicate members:
Provided that at least seventy five per cent of the net offer to the public proposed to be compulsorily allotted to qualified institutional buyers for the purpose of compliance of the eligibility conditions specified in sub-regulation (2) of Regulation 26 and Regulation 27 cannot be underwritten.

(3) The issuer shall enter into underwriting agreement with the book runner, who in turn shall enter into underwriting agreement with syndicate members, indicating therein the number of specified securities which they shall subscribe to at the predetermined price in the event of undersubscription in the issue.

(4) If syndicate members fail to fulfil their underwriting obligations, the ***lead book runner*** shall fulfil the underwriting obligations.

(5) The book runners and syndicate members shall not subscribe to the issue in any manner except for fulfilling their underwriting obligations.

(6) In case of every underwritten issue, the lead merchant banker or the lead book runner shall undertake minimum underwriting obligations as specified in the Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992.

(7) Where hundred per cent. of the offer through offer document is underwritten, the underwriting obligations shall be for the entire hundred per cent. of the offer through offer document and shall not be restricted upto the minimum subscription level.

It should be noted that as per the latest SEBI Regulations underwriting is not mandatory.

Payment of Underwriting Commission

Rule 13 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 states that :

A company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions, namely—

(a) the payment of such commission shall be authorized in the company's articles of association;

(b) the commission may be paid out of proceeds of the issue or the profit of the company or both;

(c) the rate of commission paid or agreed to be paid shall not exceed, in case of shares, ***five percent*** of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed ***two and a half per cent*** of the price at which the debentures are issued, or as specified in the company's articles, whichever is less;

(d) the prospectus of the company shall disclose— (i) the name of the underwriters; (ii) the rate and amount of the commission payable to the underwriter; and and (iii) the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally.

(e) there shall not be paid commission to any underwriter on securities which are not offered to the public for subscription;

(f) a copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the prospectus for registration.

The Companies (Meetings of Board and its Powers) Rules, 2014 states that : "A company having paid-up capital of ₹ 10 crore rupees or more shall not pay underwriting commission more than 1% without proper approval of the company by a special resolution."

In this regard, the following points are to be noted:
(1) No underwriting commission is payable on the shares taken up by the promoters, employees, directors, business associates, etc. (2) Commission is payable on the whole issue underwritten irrespective of the fact that whole of the issue may be takenover by the public.

Types of Underwriting Agreement

There are two types of underwriting agreement : (a) conditional; and (b) firm.

Conditional underwriting : Under this type of agreement, the underwriter agrees to take up agreed proportion of shares, not taken up by the public. If the shares are fully subscribed by the public, the underwriter does not take up any share.

Firm underwriting : Under this type of agreement, the underwriter agrees to take up a specified number of shares irrespective of the number of shares subscribed for by the public. Unless it has otherwise agreed, the underwriters' liability is determined without considering the number of shares taken up 'firm' by him..

Marked and Unmarked Applications

'Marked' applications are those applications which bear the stamp of an underwriter. If the issue is not fully subscribed, 'marked' applications shall be applied in reduction of underwriter's liability.

The 'unmarked' applications are those applications which bear no stamp of an underwriter. These applications are received by the company directly from the public. The ***distinction*** between marked and unmarked applications becomes immaterial when the whole issue is subscribed by only one underwriter. When there are more than one underwriters, the unmarked applications are divided amongst Underwriters in the ratio of their gross liability. When the issue is fully subscribed, the distinction between marked and unmarked applications becomes immaterial.

Full and Partial Underwriting

When the whole issue is underwritten by the underwriter(s) it is called ***full underwriting***. When a part (say 75%) of the whole issue is underwritten by the underwriter(s) it is called ***partial underwriting***. In this case the company is treated as having underwritten the balance of shares.

Accounting Entries

1. For Commission/brokerage due

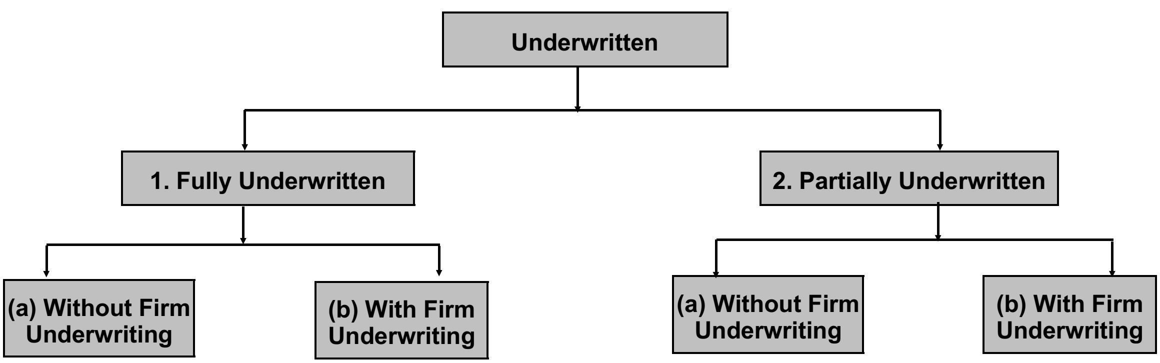
Commission/Brokerage Account	Dr.
To Underwriter Account	
To Broker Account	

2. For payment of Commission/brokerage

Underwriter Account	Dr.
Broker Account	Dr.
To Bank Account	[Cheque]
To Share Capital Account	[Shares]
To Debentures Account	[Debentures]

Determination of Liability in respect of Underwriting Contract

The nature of underwriting contract determines the liability of the underwriter. The different types of underwriting contract with their subdivisions can be shown with the help of the following diagram:



1(a) When the Issue is Fully Underwritten [without Firm Underwriting]

If the entire issue has been underwritten by ***one underwriter***, the determination of his liability is very simple. The total number of applications (both marked and unmarked) are deducted from the number of shares underwritten and the resultant figure is treated as a liability of the Underwriter. ***For example***, X Ltd. issued 1,00,000 equity shares of ₹ 10 each. The issue was fully underwritten by A. However, the company received applications for 80,000 shares which includes marked applications for 60,000 shares.

Here, A's liability will be 1,00,000 – 60,000 – 20,000 = 20,000 shares. A would get full credit for the unmarked 20,000 applications.

If the entire issue has been underwritten by ***a number of underwriters***, certain difficulties may arise in respect of division of unmarked applications.

The unmarked applications can be divided between the underwriters in the following two ways.

Method 1

Under this method, all unmarked applications are divided between the underwriters in the ratio of ***gross liability*** of individual underwriter. For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability (if it has not been given) of individual underwriter on the basis of agreed ratio. For example, X Ltd. issued 1,00,000 Equity shares of ₹ 10 each. The issue was underwritten as follows: A — 30%; B — 40% and C — 30%. Here, the gross liability will be : A — 30% of 1,00,000 = 30,000 shares; B — 40% of 1,00,000 = 40,000 shares and C 30% of 1,00,000 = 30,000 shares.

Step 2 Subtract marked applications from gross liability of respective underwriters.

Step 3 Determine the number of unmarked applications. (Unmarked application = Total applications received less marked applications). Divide unmarked applications between different underwriters in the ***ratio of gross liability***, as per our example, in the ratio of 3:4:3. If the resultant figures are all positive or zero, then stop here. Now these figures represents the net liability of each underwriter.

If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all negative figures and divide the resultant between the underwriters having positive figures in the ratio of gross liability ***inter se*** (for details see ***Illustration 3***).

Repeat ***Step 4*** unless all figures are non-negative. Now these figures represent the net liability of each underwriter.

Method 2

Under this method, all unmarked applications are divided between the underwriters in the ratio of ***gross liability less marked applications***. For determining the liability of individual underwriter, following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications from gross liability of respective underwriters. If some of the resultant figures are negative, then add all negative figures and divide their sum in the ratio of gross liability ***inter se*** (for details, See ***Illustration 3*** alternative solution).

Step 3 Determine the number of unmarked applications. Divide unmarked applications between different underwriters in the ***ratio of gross liability less marked applications***, i.e., the resultant figures of ***Step 2***. If the resultant figures of Step 3 are ***all positive*** or zero, then stop here. Now these figures represent the net liability of each underwriter. If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all negative figures and divide their sum between the underwriters having positive figures in the same ***ratio of Step 3***. Repeat Step 4 unless all figures are non-negative. Now these figures represents the net liability of each underwriter.

Illustration 1

A Ltd. issued 1,00,000 equity shares. The whole of the issue was underwritten as:

X — 40%; Y — 30%; and Z —30%.

Applications for 80,000 shares were received in all, out of which applications for 20,000 shares had the stamp of X; those for 10,000 shares had that of Y; and 20,000 shares had that of Z. The remaining applications for 30,000 shares did not bear any stamp. Show the liability of the Underwriters. ***[C.S. (Inter) — Adapted]***

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	X	Y	Z
Gross liability (X – 40%; Y – 30%; and Z – 30%)	40,000	30,000	30,000
Less: Marked applications	20,000	10,000	20,000
	20,000	20,000	10,000
Less: Unmarked applications (Note 1)	12,000	9,000	9,000
Net liability	8,000	11,000	1,000

Working Notes:

(1) Total number of applications received = 80,000. Out of 80,000 only 50,000 applications are marked (X — 20,000; Y — 10,000; and Z — 20,000). Therefore, unmarked applications = 80,000 – 50,000 = 30,000. Unmarked applications are distributed amongst the underwriters in the ratio of their gross liability i.e. 4:3:3.

Alternatively, the unmarked applications can be allocated in the ratio of liability after credit of marked applications. The solution in that case will be as follows:

Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	X	Y	Z
Gross liability (X – 40%; Y – 30%; and Z – 30%)	40,000	30,000	30,000
Less: Marked applications	20,000	10,000	20,000
Gross Liability less marked applications	20,000	20,000	10,000
Less: Unmarked applications (2:2:1)	12,000	12,000	6,000
Net Liability	8,000	8,000	4,000

The liability of each underwriter may vary widely according to the choice of the method adopted. Generally, the underwriting contract contains a provision in this respect.
In the examination if nothing is mentioned, the position should be clarified by way of a note.

Illustration 2

On 1st January, 2016, Moon Ltd. issued a prospectus inviting applications for subscription in 10,00,000 equity shares of ₹ 10 each. The whole issue was fully underwritten by A, B, C and D as :

A — 30%; B — 25%.; C — 35%; and D — 10%.

The applications were received for 8,00,000 shares of which marked applications were as follows :

A — 1,80,000; B — 2,00,000; C — 2,03,000; and D — 1,67,000.

Find out the liability of individual underwriters.

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	A	B	C	D
Gross Liability (A — 30%; B — 25%; C — 35%; D — 10%)	3,00,000	2,50,000	3,50,000	1,00,000
Less: Marked applications	1,80,000	2,00,000	2,03,000	1,67,000
	1,20,000	50,000	1,47,000	(67,000)
Less: Unmarked applications (Note 2)	15,000	12,500	17,500	5,000
Resultant Liability (or surplus)	1,05,000	37,500	1,29,500	(72,000)
Less: Surplus of D allocaed to A, B and C in the ratio of gross liability (6:5:7)	24,000	20,000	28,000	72,000
Net Liability	81,000	17,500	1,01,500	Nil

Working Notes :

(1) Calculation of Unmarked Applications :

Total number of applications received	8,00,000
Less: Marked applications (A : 1,80,000 + B : 2,00,000 + C : 2,03,000 + D : 1,67,000)	7,50,000
Unmarked applications	50,000

(2) Share of Unmarked Applications (Based on 1st Method) :

A — 30% of 50,000 = 15,000; B — 25% of 50,000 = 12,500; C — 35% of 50,000 = 17,500; and D — 10% of 50,000 = 5,000.

Illustration 3

Newton Ltd. incorporated on 1st January 2016 issued a prospectus inviting applications for 20,000 equity shares of ₹ 10 each. The whole issue was fully underwritten by A, B and C as follows:

A — 10,000 shares; B — 6,000 shares; and C — 4,000 shares.

Applications were received for 16,000 shares of which marked applications were as follows:

A — 8,000 shares; B — 2,850 shares; and C — 4,150 shares.

You are required to find out the liability of individual underwriters.

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	A	B	C
Gross liability	10,000	6,000	4,000
Less: Marked applications	8,000	2,850	4,150
	2,000	3,150	(150)
Less: Unmarked applications (Note 1)	500	300	200
Resultant liability (or surplus)	1,500	2,850	(350)
Less: Surplus of C allotted to A & B in the ratio of gross liability (5:3)	219	131	350
Net liability	1,281	2,719	Nil

Working Notes:

(1) Total number of applications received = 16,000. Number of marked applications = 15,000 (A — 8,000; B — 2,850; and C — 4,150). Therefore, unmarked applications = 16,000 – 15,000 = 1,000. Unmarked applications are allocated in the ratio of gross liability i.e., 5:3:2.

Illustration 4

Export Ltd. incorporated on 1st January, 2016 issued a prospectus inviting applications for 5,00,000 equity shares of ₹ 10 each.

The whole issue was fully underwritten by K,B,D, M as :

K — 2,00,000; B — 1,50,000; D — 1,00,000; and M — 50,000.

The applications were received for 4,50,000 shares of which marked applications were as follows:

K — 2,20,000; B — 90,000; D — 1,10,000; and M — 10,000.

Find out the liability of individual underwriters.

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	K	B	D	M
Gross liability	2,00,000	1,50,000	1,00,000	50,000
Less: Marked applications	2,20,000	90,000	1,10,000	10,000
	(20,000)	60,000	(10,000)	40,000
Less: Unmarked applications (Note 1)	8,000	6,000	4,000	2,000
Resultant liability (or surplus)	(28,000)	54,000	(14,000)	38,000
Less: Surplus of K & D allocated to B & M in the ratio of gross liability	28,000	31,500	14,000	10,500
Net liability	Nil	22,500	Nil	27,500

Working Notes:

(1) Total number of applications received = 4,50,000. Number of marked applications (K — 2,20,000; B — 90,000; D — 1,10,000; and M — 10,000) = 4,30,000. Therefore, unmarked applications = 20,000. Unmarked applications are allocated in the ratio of gross liability i.e., 4:3:2:1.

Alternative Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	K	B	D	M
Gross liability	2,00,000	1,50,000	1,00,000	50,000
Less: Marked applications	2,20,000	90,000	1,10,000	10,000
	(20,000)	60,000	(10,000)	40,000
Less: Surplus of K & D (20,000 + 10,000) allocated to B & M in the ratio of gross liability	20,000	(22,500)	10,000	(7,500)
Gross liability less marked application	Nil	37,500	Nil	32,500
Less: Unmarked application in the ratio of 37,500:32,500 or 15:13		10,714		9,286
Net liability	Nil	26,786	Nil	23,214

1 (b) When the Issue is Fully Underwritten [with Firm Underwriting]

If the entire issue has been underwritten by a number of underwriters with some firm underwriting, certain new difficulties may arise regarding the ***benefit of firm underwriting***. There are ***two alternative ways***:

(i) The benefit of firm underwriting is not given to individual underwriter, or

(ii) the benefit of firm underwriting is given to individual underwriter.

(i) The benefit of firm underwriting is not given to individual Underwriter:

For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications (excluding firm underwriting) from gross liability of respective underwriters. If some of the resultant figures are found negative, then add all negative figures and divide the resultant in the ratio of gross liability.

Step 3 Determine the number of unmarked applications as follows:

Total subscriptions (excluding firm underwriting)	******
Less: Marked applications (excluding firm underwriting)	******
Unmarked applications by public	******
Add: Applications under firm underwriting	******
Total unmarked applications	******

Divide the above calculated unmarked applications in the ratio of ***gross liability***.

If the resultant figures of ***Step 3*** are all positive or zero, then it represents ***net liability*** as per agreement. After this step, go to ***Step 5*** (skip ***Step 4***).

If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all the negative figures and divide the resultant between the underwriters having positive figures in the ratio of ***gross liability***. Repeat Step 4 unless all figures are non-negative. Now these figures represent the ***net liability*** as per agreement. After this step, go to ***Step 5***.

Step 5 Add firm underwriting with the ***net liability*** as per agreement. The resultant figures represent ***total liability***.

Key points to remember

(1) Firm underwriting is treated as unmarked applications and divided in the ratio of gross liability.

(2) The liability of underwriter consists of: (a) Net liability as per agreement; and (b) firm underwriting.

Illustration 5

J Ltd. issued 20,000 shares which were underwritten as follows:

A — 12,000 shares; B — 5,000 shares; and C — 3,000 shares.

The underwriters made applications for firm underwriting as:

A — 1,600 shares; B — 600 shares; and C — 2,000 shares.

The total subscriptions excluding firm underwriting but including marked applications were for 10,000 shares. The marked applications were : A — 2,000 shares; B — 4,000 shares; and C — 1,000 shares.

You are required to show the allocation of liability of the underwriters.

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	A	B	C
Gross liability	12,000	5,000	3,000
Less: Marked applications (excluding firm underwriting)	2,000	4,000	1,000
	10,000	1,000	2,000
Less: Unmarked applications in the ratio of gross liability (Note 1)	4,320	1,800	1,080
Resultant liability (or surplus)	5,680	(800)	920
Less: Surplus of B allocated to A & C in the ratio of 12:3	(640)	800	(160)
Net liability as per agreement	5,040	Nil	760
Add: Firm underwriting	1,600	600	2,000
Total liability	6,640	600	2,760

Working Notes : Under this method, firm underwriting is treated as 'unmarked application' and it is dividend in the ratio of gross liability. Total unmarked applications are calculated as follows :

(1) Calculation of unmarked applications	No.
Total subscriptions (excluding firm underwriting)	10,000
Less: Marked applications (excluding firm underwriting)	7,000
Unmarked applications by public	3,000
Add: Applications under firm underwriting	4,200
Total unmarked applications	7,200
Unmarked applications are allotted in the ratio of gross liability i.e., 12:5:3	

(2) Total allocation of shares	No.
Unmarked applications by public	3,000
Marked applications by public	7,000
Total liability (6,640 + 600 + 2,760)	10,000
	20,000

Illustration 6

Calcutta Ltd. offered to the public to issue 18,00,000 shares at par. These offer was underwritten by three underwriters: Chetan, Dola and Ellias equally with firm underwriting 60,000 shares each. Subscriptions totalled 15,80,000 shares including the marked forms which were :

Chetan — 5,00,000 shares; Dola — 5,40,000 shares; Ellias — 4,40,000 shares.

The underwriters had applied for the number of shares covered by firm undertaking.

Calculate the liability of the underwriters (No. of shares).

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	Chetan	Dola	Ellias
Gross Liability	6,00,000	6,00,000	6,00,000
Less: Marked applications (excluding firm underwriting)	5,00,000	5,40,000	4,40,000
	1,00,000	60,000	1,60,000
Less: Unmarked applications in the ratio of gross liability (Note 1)	93,333	93,334	93,333
Resultant Liability (or surplus)	6,667	(33,334)	66,667
Less: Surplus of Dola allocated to Chetan & Ellias equally	(16,667)	33,334	(16,667)
Net Liability as per agreement	(10,000)	Nil	50,000
Less: Surplus of Chetan allocated to Ellias	10,000	—	(10,000)
	Nil	Nil	40,000
Add: Firm underwriting	60,000	60,000	60,000
Total Liability	60,000	60,000	1,00,000

Working Notes :

(1) Under this method, firm underwriting is treated as 'unmarked application' and it is divided in the ratio of gross liability. Total unmarked applications are calculated as follows :

(2) Calculation of unmarked applications	No.	(3) Total allocation of shares	No.
Total subscriptions (excluding firm underwriting)	15,80,000	Unmarked applications by public	1,00,000
Less: Marked applications (excl. firm underwriting)	14,80,000	Marked applications by public	14,80,000
Unmarked applications by public	1,00,000	Total liability (60,000 + 60,0000 + 1,00,000)	2,20,000
Add: Applications under firm underwriting (60,000 x 3)	1,80,000		18,00,000
Total unmarked applications	2,80,000		

Unmarked applications are allotted equally.

Illustration 7

X Ltd. has an authorised capital of ₹ 50,00,000 divided into 5 lacs shares of ₹ 10 each. the company issued 1,00,000 shares for subscription to the public at a premium of ₹ 5 each. the entire issue was underwritten as follows :

A — 60,000 shares (firm underwriting 10,000 shares)

B — 30,000 shares (firm underwriting 4,000 shares)

C — 10,000 shares (firm underwriting 2,000 shares)

Of the total issue, only 90,000 shares including firm underwriting were subscribed for. Marked application forms excluding firm underwriting were :

A — 32,000 shares; B — 20,000 shares; C — 8,000 shares.

Calculate the liability of each underwriter giving the benefit of firm underwriting to all.

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	A	B	C
Gross Liability	60,000	30,000	10,000
Less: Marked applications (excluding firm underwriting)	32,000	20,000	2,000
	28,000	10,000	2,000
Less: Unmarked applications in the ratio of gross liability (Note 1)	18,000	9,000	3,000
Resultant Liability (or surplus)	10,000	1,000	(1,000)
Less: Surplus of C allocated to A & B in the ratio of 2:1	(667)	(333)	1,000
Net Liability as per agreement	9,333	667	Nil
Add: Firm underwriting	10,000	4,000	2,000
Total Liability	19,333	4,667	2,000

Working Notes :

(1) Calculation of unmarked applications	No.	**(2) Total allocation of shares**	No.
Total subscriptions (excluding firm underwriting) [90,000 – 10,000 – 4,000 – 2,000]	74,000	Unmarked applications by public	14,000
Less: Marked applications (excl. firm underwriting)	60,000	Marked applications by public	60,000
Unmarked applications by public	14,000	Total liability (19,333 + 4,667 + 2,000)	26,000
Add: Firm underwriting	16,000	**Total Issue**	1,00,000
Total unmarked applications	30,000		

Unmarked applications are allotted in the ratio of gross liability, i.e., 6:3:1. A— 18,000; B — 9,000; C — 3,000.

Illustration 8

ABC Ltd. came up with public issue of 3,00,000 equity shares of ₹ 10 each at ₹ 15 per share. P, Q and R took underwriting of the issue in ratio of 3 : 2 : 1 with the provisions of firm underwriting of 20,000, 14,000 and 10,000 shares respectively.

Applications were received for 2,40,000 shares excluding firm underwriting. The marked applications from public were received as under :

P – 60,000; Q – 50,000; R – 60,000.

Compute the liability of each underwriter as regards the number of shares to be taken up assuming that the benefit of firm underwriting is not given to individual underwriters.

Solution **Statement Showing the Liability of Underwriters** **[Figures in No. of Shares]**

Underwriters	P	Q	R
Gross liability (3 : 2 : 1)	1,50,000	1,00,000	50,000
Less: Marked applications (excluding firm underwriting)	60,000	50,000	60,000
	90,000	50,000	(10,000)
Less: Unmarked applications in the ratio of gross liability (Note 1)	57,000	38,000	19,000
Resultant liability (or surplus)	33,000	12,000	(29,000)
Less: Surplus of R allotted to P and Q in the ratio of gross liability (3 : 2)	17,400	11,600	29,000
Net Liability as per Agreement	15,600	400	Nil
Add: Firm underwriting	20,000	14,000	10,000
Total liability	35,600	14,400	10,000

Working Notes:

(1) Calculation of unmarked applications	No.	**(2) Total allocation of shares**	No.
Total subscriptions (excluding firm underwriting)	2,40,000	Unmarked applications by public	70,000
Less: Marked applications (excluding firm underwriting)	1,70,000	Marked applications by public	1,70,000
			2,40,000
Unmarked applications by public	70,000	Total liability (35,600 + 14,400 + 10,000)	60000
Add: Applications under firm underwriting	44,000		3,00,000
Total unmarked applications	1,14,000		

Unmarked applications are allotted in the ratio of gross liability, i.e., 3 : 2 : 1.

Illustration 9

Sam Ltd invited applications from public for 1,00,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share. The entire issue was underwritten by the underwriters A, B, C and D to the extent of 30%, 30%, 20% and 20% respectively with the provision of firm underwriting of 3,000, 2000, 1,000 and 1,000 shares respectively. The underwriters were entitled to the maximum commission ***permitted by law***.

The company received applications for 70,000 shares from public out of which applications for 19,000, 10,000, 21,000 and 8,000 shares were marked in favour of A, B, C and D respectively.

Calculate the liability of each of the underwriters. Also ascertain the underwriting commission payable to the different underwriters.

Solution

Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	A	B	C	D
Gross liability (3 : 3 : 2 : 2)	30,000	30,000	20,000	20,000
Less: Marked applications	19,000	10,000	21,000	8,000

	11,000	20,000	(1,000)	12,000
Less: Unmarked applications (Note 1)	5,700	5,700	3,800	3,800
Resultant Liability (or Surplus)	5,300	14,300	(4,800)	8,200
Less: Surplus of C allocated to A, B and D in the ratio of 3 : 3 : 2	1,800	1,800	4,800	1,200
Net Liability as per agreement	3,500	12,500	Nil	7,000
Add: Firm underwriting	3,000	2,000	1,000	1,000
Total liability	6,500	14,500	1,000	8,000

As per ***Rule 13(c) of the Companies (Prospectus and Allotment of Securities) Rules, 2014***, the rate of commission for shares shall not exceed 5% of the issue price (face value + premium) or a rate authorised by the articles, whichever is less.

It is assumed that 5% is less than the rate permitted by the articles.

Thus, the commission payable to :	₹
A : 30,000 × ₹ 15 × 5%	22,500
B : 30,000 × ₹ 15 × 5%	22,500
C : 20,000 × ₹ 15 × 5%	15,000
D : 20,000 × ₹ 15 × 5%	15,000
Total	75,000

Working Note :

(1) Under this method, firm underwriting is treated as unmarked application and it is to be divided in the ratio of gross liability (i.e., 3 : 3 : 2 : 2). Total unmarked applications are calculated as follows :

(a) Calculation of Unmarked Applications	No.	**(b) Total Allocation of Shares**	No.
Applications received	70,000	Marked applications	58,000
Less: Marked applications	58,000	Unmarked applications	12,000
	12,000	Total liability	30,000
Add: Applications under firm underwriting	7,000		1,00,000
Total unmarked applications	19,000		

Illustration 10

A joint stock company issued 15,00,000 equity shares of ₹ 10 each at par. 30% of the issue was reserved for the promoters and the balance was offered to the general public, the entire amount being asked for with the applications.

P, Q and R agreed to underwrite the public issue in the ratio of 3 : 1 : 1 respectively, and also agreed to firm underwriting of 30,000, 20,000 and 10,000 shares respectively.

The underwriting commission was fixed at 2%. The marked applications were as follows :

P — 5,50,000 shares; Q — 2,00,000 shares; R — 1,50,000 shares.

Unmarked applications excluding for shares underwritten firm totalled 50,000 shares.

You are required to —

(i) ascertain the number of shares taken up by each one of the underwriters.

(ii) calculate the amount received from or paid to each one of the underwriters by the company in settlement.

Solution

Total number of shares issued	15,00,000
Less: Shares reserved for promoters (30%)	4,50,000
Shares offered to general public	10,50,000

Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	P	Q	R
Gross liability (3 : 1 : 1)	6,30,000	2,10,000	2,10,000
Less: Marked applications	5,50,000	2,00,000	1,50,000
	80,000	10,000	60,000
Less: Unmarked applications (Note 1)	66,000	22,000	22,000
Resultant liability (or Surplus)	14,000	(12,000)	38,000
Less: Surplus of Q allocated to P and R in the ratio of 3 : 1	9,000	12,000	3,000
Net Liability as per agreement	5,000	Nil	35,000
Add: Firm underwriting	30,000	20,000	10,000
Total liability	35,000	20,000	45,000

Statement Showing the Amount Due From (Due To) Underwriters

Underwriters	P	Q	R
Number of shares to be subscribed	35,000	20,000	45,000
Amount payable @ ₹ 10 per share (₹)	3,50,000	2,00,000	4,50,000
Less: Amount paid on firm application @ ₹ 10 (assuming the entire money payable on application)	3,00,000	2,00,000	1,00,000
Balance Payable	50,000	Nil	3,50,000
Underwriting commission @ 2% on the face value of shares underwritten	1,26,000	42,000	42,000
Amount paid to Underwriters	(76,000)	(42,000)	—
Amount received from Underwriters	—	—	3,08,000

Working Note :

(1) Under this method firm underwriting is treated as 'unmarked application' and it is to be divided in the ratio of gross liability (i.e., 3 : 1 : 1).
Total unmarked applications = 50,000 (of public) + 30,000 (firm underwriting of P) + 20,000 (firm underwriting of Q) + 10,000 (firm underwriting of R) = 1,10,000.
P will get credit for 66,000 shares (1,10,000 / 5 × 3);
Q will get credit for 22,000 shares (1,10,000 / 5 × 1) and
R will get credit for 22,000 shares (1,10,000 / 5 × 1).

Illustration 11

Libra Ltd. came up with an issue of 20,00,000 equity shares of ₹ 10 each at par. 5,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters — Anand, Vijay and Ashok — equally, with firm underwriting of 50,000 shares each. Subscriptions totalled 12,97,000 shares (excluding firm underwriting) but including the marked form which were:

Anand — 4,25,000 shares; Vijay — 4,50,000 shares; Ashok — 3,50,000 shares.

The underwriters had applied for number of shares covered by firm underwriting. The amounts payable on applications and allotment were ₹ 2.50 and ₹ 2 respectively. The agreed commission was 2.5%.

Pass summary journal entries for:

(a) The allotment of shares to the underwriters;
(b) the commission due to each of them; and
(c) the net cash paid and/or received.

Note: Unmarked applications are to be credited to the underwriters equally.

Solution

In the books of Libra Ltd.
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	3,75,000	
	To Share Application A/c			3,75,000
	(Being application money received on firm application for 50,000 shares each @ ₹ 2.50 from Anand, Vijay and Ashok)			
	Anand A/c	Dr.	1,00,000	
	Vijay A/c	Dr.	1,00,000	
	Ashok A/c	Dr.	3,38,500	
	Share Application A/c	Dr.	3,75,000	
	To Equity Share Capital A/c			9,13,500
	(Being allotment of shares to Anand – 50,000; Vijay – 50,000; and Ashok – 1,03,000; application and allotment money credited to Share Capital Account, as per Board's Resolution No. ... dated ...)			
	Underwriting Commission A/c	Dr.	3,75,000	
	To Anand A/c			1,25,000
	To Vijay A/c			1,25,000
	To Ashok A/c			1,25,000
	(Being amount payable to Anand; Vijay and Ashok @ 2.5% on ₹ 50,00,000 each for shares underwritten)			
	Anand A/c (Note 4)	Dr.	25,000	
	Vijay A/c	Dr.	25,000	
	To Bank A/c			50,000
	(Being the amount paid to Anand and Vijay in respect of underwriting commission after adjusting the amount payable on shares allotted)			
	Bank A/c (Note 4)	Dr.	2,13,500	
	To Ashok A/c			2,13,500
	(Being the balance amount received from Ashok on shares allotted after adjusting underwriting commission)			

If the benefit of firm underwriting is not given to individual underwriter.

Working Notes: (1) Statement Showing the Liability of Underwriters [Figures — No. of shares]

Underwriters	Anand	Vijay	Ashok
Gross liability	5,00,000	5,00,000	5,00,000
Less: Marked applications (excluding firm underwriting)	4,25,000	4,50,000	3,50,000
	75,000	50,000	1,50,000
Less: Unmarked applications allotted in the ratio of gross liability (Note below)	74,000	74,000	74,000
Resultant liability (or surplus)	1,000	(24,000)	76,000
Less: Surplus of Vijay allocated to Anand and Ashok equally	(12,000)	24,000	(12,000)
	(11,000)	Nil	64,000
Less: Surplus of Anand allocated to Ashok totally	11,000	—	(11,000)
Net liability as per agreement	Nil	Nil	53,000
Add: Firm underwriting	50,000	50,000	50,000
Total liability	50,000	50,000	1,03,000

(2) Calculation of unmarked applications

	No.
Total subscriptions (excluding firm underwriting)	12,97,000
Less: Marked applications (excl. firm underwriting)	12,25,000
Unmarked applications by public	72,000
Add: Applications under firm underwriting	1,50,000
Total unmarked applications	2,22,000

(3) Total allocation of shares

	No.
Unmarked applications by public	72,000
Marked applications by public	12,25,000
Total liability (₹ 50,000 + 50,000 + 1,03,000)	2,03,000
	15,00,000

(4) Statement Showing the Amount Due from (due to) Underwriters

Underwriters		Anand	Vijay	Ashok
Number of shares to be subscribed		50,000	50,000	1,03,000
Amount payable @ ₹ 4.50 per share	₹	2,25,000	2,25,000	4,63,500
Less: Amount paid on firm application for 50,000 shares @ ₹ 2.50 each		1,25,000	1,25,000	1,25,000
Balance payable		1,00,000	1,00,000	3,38,500
Underwriting commission @ 2.5% on ₹ 50,00,000 each		1,25,000	1,25,000	1,25,000
Amount paid / received		(25,000)	(25,000)	2,13,500

Illustration 12

A joint stock company resolved to issue 10 lakh equity shares of ₹ 10 each at a premium of ₹ 1 per share. One lakh of these shares were taken up by the directors of the company, their relatives, associates and friends, the entire amount being received forthwith. The remaining shares were offered to the public, the entire amount being asked for with applications.

The issue was underwritten by X, Y and Z for a commission @ 2% of the issue price, 65% of the issue was underwritten by X, while Y's and Z's shares were 25% and 10% respectively.

Their firm underwriting was as follows :

X 30,000 shares, Y 20,000 shares and Z 10,000 shares. The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with members of the general public.

Marked applications were as follows : X 1,19,500 shares; Y 57,500 shares and Z 10,500 shares.

Unmarked applications totalled 7,00,000 shares.

Accounts with the underwriters were promptly settled.

You are required to :

(i) Prepare a statement calculating underwriter's liability for shares other than shares underwritten firm.

(ii) Pass journal entries for all the transactions including cash transactions.

Solution

Total number of shares issued	10,00,000
Less: Shares taken by the directors and others	1,00,000
Shares offered to general public	9,00,000

Statement Showing the Liability of Underwriters [Figures — No. of shares]

Underwriters	X	Y	Z
Gross liability (65% : 25% : 10%)	5,85,000	2,25,000	90,000
Less: Marked applications	1,19,500	57,500	10,500
	4,65,500	1,67,500	79,500
Less: Unmarked applications in the ratio of gross liability	4,55,000	1,75,000	70,000

Resultant Liability (or Surplus)	10,500	(7,500)	9,500
Less: Surplus of Y allocated to X and Z in the ratio of 65 : 10	6,500	7,500	1,000
Net Liability as per agreement	4,000	Nil	8,500

In the Books of . . .
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	11,00,000	
	To Equity Share Capital A/c			10,00,000
	To Securities Premium A/c			1,00,000
	(Being the issue of 1,00,000 equity shares of ₹ 10 each at a premium of Re 1 per share to the directors, their relatives and friends as per Board's Resolution No. . . . dated . . .)			
	Bank A/c	Dr.	97,62,500	
	To Share Application A/c			97,62,500
	(Being application money received on 8,87,500 shares @ ₹ 11 each)			
	X A/c	Dr.	44,000	
	Z A/c	Dr.	93,500	
	Share Application A/c	Dr.	97,62,500	
	To Equity Share Capital A/c			90,00,000
	To Securities Premium A/c			9,00,000
	(Being allotment of shares to X — 4,000 and Z — 8,500, application money credited to Equity Share Capital Account and Securities Premium Account as per Board's Resolution No. . . . dated . . .)			
	Underwriting Commission A/c	Dr.	1,98,000	
	To X A/c (Note 1)			1,28,700
	To Y A/c (Note 1)			49,500
	To Z A/c (Note 2)			19,800
	(Being the amount payable to X, Y and Z as underwriting commission @ 2% of the issue price)			
	X A/c	Dr.	84,700	
	Y A/c	Dr.	49,500	
	To Bank A/c			1,34,200
	(Being the amount paid to X and Y in respect of underwriting commissio n after adjusting amount payable on shares allotted)			
	Bank A/c	Dr.	73,700	
	To Z A/c			73,700
	(Being balance money recd. from Z on shares allotted after adjusting underwriting commission)			

Working Note : (1) Statement Showing the Amount Due From (Due To) Underwriters

Underwriters		X	Y	Z
Number of shares to be subscribed as per agreement (excluding firm underwriting)		4,000	Nil	8,500
Amount payable @ ₹ 11 per share	(₹)	44,000	—	93,500
Underwriting commission @ 2%				
X — on ₹ 64,35,000		1,28,700	—	—
Y — on ₹ 24,75,000		—	49,500	—
Z — on ₹ 9,90,000		—	—	19,800
Amount paid / received		(84,700)	(49,500)	73,700

(ii) The benefit of firm underwriting is given to individual underwriter

For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications (excluding firm underwriting) from gross liability of respective underwriters. If some of the resultant figures are found negative, then add all negative figures and divide their sum in the ratio of gross liability.

Step 3 Determine the number of unmarked applications as follows:

Total subscriptions (excluding firm underwriting)	******
Less: Marked applications (excluding firm underwriting)	******
Unmarked applications by public	******

Divide the above calculated unmarked application in the ***ratio of gross liability***.

Step 4 Subtract "firm underwriting" of individual underwriter from the respective figures of Step 3.

If the resultant figures of ***Step 4*** are all positive or zero, then that represents net liability as per agreement. After this step, go to ***Step 6*** (skip ***Step 5***). If some of the resultant figures are negative, then continue to Step 5.

Step 5 Add all negative figures and divide it between the underwriters having positive figures in the ratio of gross liability. Repeat ***Step 5*** unless all figures are non-negative. Now these figures represent the *net liability* as per agreement. After this step, go to ***Step 6***.

Step 6 Add firm underwriting with the net liability as per agreement. The resultant figures represent *total liability*.

Key points to remember

(1) Firm underwriting is not treated as unmarked applications.
(2) Firm underwriting is credited to individual underwriters separately.
(3) The liability of Underwriter consists of:
(a) Net liability as per agreement; and (b) firm underwriting.
Students should observe illustration 9 very carefully to distinguish the impact of both the methods.

Illustration 13

Norman Ltd issued 80,000 equity shares which were underwritten as follows :

Mr A	48,000 equity shares
Messrs B & Co.	20,000 equity shares
Messrs C Corp.	12,000 equity shares

The above mentioned underwriters made applications for 'firm' underwritings as follows :

Mr. A	6,400 equity shares
Messrs B & Co.	8,000 equity shares
Messrs C Corp.	2,400 equity shares

The total applications excluding 'firm' underwriting, but including marked applications were for 40,000 equity shares.

The marked applications were as under :

Mr. A	8,000 equity shares
Messrs B & Co.	10,000 equity shares
Messrs C Corp.	4,000 equity shares

(The underwriting contracts provide that underwriters be given credit for 'firm' applications and that credit for unmarked applications be given in proportion to the shares underwritten.). You are required to show the allocation of liability. Workings will be considered as a part of your answer.

Solution **Statement Showing the Liability of Underwriters** **[Figures — No. of shares]**

Underwriters	Mr A	M/s B & Co	M/s C Corp
Gross liability	48,000	20,000	12,000
Less: Marked applications (excluding firm underwriting)	8,000	10,000	4,000
	40,000	10,000	8,000
Less: Unmarked applications (Note 1)	10,800	4,500	2,700
	29,200	5,500	5,300
Less: Firm underwriting	6,400	8,000	2,400
	22,800	(2,500)	2,900
Less: Surplus of M/s B & Co allocated to Mr A and M/s C Corp in the ratio of 12 : 3 or 4 : 1	2,000	2,500	500
Net Liability as per agreement	20,800	—	2,400
Add: Firm underwriting	6,400	8,000	2,400
Total liability	27,200	8,000	4,800

Working Notes :

(1) Under this method, firm underwriting is not included in the unmarked application. Unmarked application of public will be credited to the underwriters in the ratio of gross liability. Here, unmarked application = 40,000 – 22,000 = 18,000 shares.
Underwriters will be given credit in the ratio of 48 : 20 : 12 or 12 : 5 : 3.

Mr A : 18,000 / 20 × 12	10,800 shares
Messrs B & Co : 18,000 / 20 × 5	4,500 shares
Messrs C Corp. : 18,000 / 20 × 3	2,700 shares
	18,000 shares

Illustration 14

Delta Ltd. issued 25,00,000 equity shares of ₹ 10 each at par. 7,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters P, Q and R in the ratio of 2 : 3 : 4 with firm underwriting of 50,000, 60,000 and 70,000 shares each respectively. Total subscription received 13,88,000 shares including marked application and excluding firm underwriting. Marked applications were as follows :

P – 3,00,000; Q – 3,50,000; and R 4,50,000.

Unmarked and surplus applications to be distributed in gross liability ratio,

Ascertain the liability of each underwriter,.

Solution **Statement Showing the Liability of Underwriters** **[Figures in No. of Shares]**

(Assuming that the benefit of firm underwriting is ***not*** given to individual underwriter.)

Underwriters	P	Q	R
Gross liability (2 : 3 : 4)	4,00,000	6,00,000	8,00,000
Less: Marked applications (excluding firm underwriting)	3,00,000	3,50,000	4,50,000
	1,00,000	2,50,000	3,50,000
Less: Unmarked applications (Note 1)	1,04,000	1,56,000	2,08,000
Resultant liability (or surplus)	(4,000)	94,000	1,42,000
Less: Surplus of A allotted to B and C in the ratio of gross liability (3 : 4)	4,000	1,714	2,286
Net Liability as per Agreement	—	92,286	1,39,714
Add: Firm underwriting	50,000	60,000	70,000
Total liability	50,000	1,52,286	2,09,714

Working Notes:

(1) Calculation of unmarked applications	No.	**(2) Total allocation of shares**	No.
Total subscriptions (excluding firm underwriting)	13,88,000	Unmarked applications by public	2,88,000
Less: Marked applications		Marked applications by public	11,00,000
(excluding firm underwriting)	11,00,000		13,88,000
Unmarked applications by public	2,88,000	Total liability (50,000 + 1,52,285 + 2,09,714)	4,12,000
Add: Applications under firm underwriting	1,80,000		18,00,000
Total unmarked applications	4,68,000		

Alternative Solution **Statement Showing the Liability of Underwriters** **[Figures in No. of Shares]**

(Assuming that the benefit of firm underwriting **is given** to individual underwriter.)

Underwriters	P	Q	R
Gross liability (2 : 3 : 4)	4,00,000	6,00,000	8,00,000
Less: Marked applications (excluding firm underwriting)	3,00,000	3,50,000	4,50,000
	1,00,000	2,50,000	3,50,000
Less: Unmarked applications (2 : 3 : 4) (Note 1)	64,000	96,000	1,28,000
	36,000	1,54,000	2,22,000
Less: Firm Underwriting	50,000	60,000	70,000
Resultant liability (or surplus)	(14,000)	94,000	1,52,000
Less: Surplus of A allotted to B and C in the ratio of gross liability (3 : 4)	14,000	(6,000)	(8,000)
Net Liability as per Agreement	Nil	88,000	1,44,000
Add: Firm underwriting	50,000	60,000	70,000
Total liability	50,000	1,48,000	2,14,000

Working Notes:

(1) Calculation of unmarked applications	No .	**(2) Total allocation of shares**	No.
Total subscriptions (excluding firm underwriting)	13,88,000	Unmarked applications by public	2,88,000
Less: Marked applications		Marked applications by public	11,00,000
(excluding firm underwriting)	11,00,000		13,88,000
Unmarked applications by public	2,88,000	Total liability (50,000 + 1,48,000 + 2,14,000)	4,12,000
			18,00,000

Illustration 15

Scorpio Ltd. came out with an issue of 45,00,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share. The promoters took 20% of the issue and the balance was offered to the public. The issue was equally underwritten by A & Co; B & Co and C & Co.

Each underwriter took firm underwriting of 1,00,000 shares each. Subscriptions for 31,00,000 equity shares were received with marked forms for the underwriters as given below :

A & Co.	7,25,000 shares
B & Co.	8,40,000 shares
C & Co.	13,10,000 shares
Total	28,75,000 shares

The underwriters are eligible for a commission of 5% on issue price of shares. The entire amount towards shares subscription has to be paid alongwith application.

You are required to :

(a) Compute the underwriters liability (number of shares);

(b) Compute the amounts payable or due to underwriters; and

(c) Pass necessary journal entries in the books of Scorpio Ltd. relating to underwriting.

Solution

Total number of shares issued	45,00,000
Less: Shares taken over by the promoter	9,00,000
Shares offered to general public	36,00,000

Solution

(a) Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	A & Co	B & Co	C & Co
Gross liability	12,00,000	12,00,000	12,00,000
Less: Marked applications	7,25,000	8,40,000	13,10,000
	4,75,000	3,60,000	(1,10,000)
Less: Unmarked applications (Note 1)	75,000	75,000	75,000
Resultant Liability (or Surplus)	4,00,000	2,85,000	(1,85,000)
Less: Firm underwriting	1,00,000	1,00,000	1,00,000
	3,00,000	1,85,000	(2,85,000)
Less: Surplus of C & Co allocated to A & Co and B & Co equally	1,42,500	1,42,500	2,85,000
Net Liability as per agreement	1,57,500	42,500	Nil
Add: Firm underwriting	1,00,000	1,00,000	1,00,000
Total liability	2,57,500	1,42,500	1,00,000

Working Notes:

(1) Calculation of unmarked applications

	No.
Total subscriptions (excluding firm underwriting)	31,00,000
Less: Marked applications	28,75,000
Total unmarked applications	2,25,000

Statement Showing the Amount Due from (due to) Underwriters

Underwriters		A & Co	B & Co	C & Co
Number of shares to be subscribed (including firm underwriting)		2,57,500	1,42,500	1,00,000
Amount payable @ ₹ 12 each	₹	30,90,000	17,10,000	12,00,000
Less: Amount paid on firm application @ ₹ 12 each on 1,00,000 shares		12,00,000	12,00,000	12,00,000
Balance payable		18,90,000	5,10,000	Nil
Underwriting commission @ 5% on 12,00,000 shares @ ₹ 12 each		7,20,000	7,20,000	7,20,000
Amount received / (paid)		11,70,000	(2,10,000)	(7,20,000)

In the books of Scorpio Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	36,00,000	
	To Share Application A/c			36,00,000
	(Being application money received on firm application for 1,00,000 shares each @ ₹ 12 each from A & Co., B & Co. and C & Co.)			
	A & Co A/c	Dr.	18,90,000	
	B & Co A/c	Dr.	5,10,000	
	Share Application A/c	Dr.	36,00,000	
	To Equity Share Capital A/c			50,00,000
	To Securities Premium A/c			10,00,000
	(Being the allotment of shares to A & Co — 2,57,500; B & Co. — 1,42,500 and C & Co. — 1,00,000. Application money transferred to share capital account and securities premium account, as per Board's Resolution No. ... dated ...)			

	Underwriting Commission A/c Dr.	21,60,000	
	To A & Co A/c		7,20,000
	To B & Co A/c		7,20,000
	To C & Co A/c		7,20,000
	(Being underwriting commission payable @ 5% on 12,00,000 shares of ₹ 10 each)		
	Bank A/c Dr.	11,70,000	
	To A & Co A/c		11,70,000
	(Being the balance amount received from C & Co)		
	B & Co A/c Dr.	2,10,000	
	C & Co A/c Dr.	7,20,000	
	To Bank A/c		9,30,000
	(Being the amount paid to B & Co and C & Co after adjustment of underwriting commission)		

Points to be noted

Unless it has been otherwise agreed, the underwriters' liability is to be determined without taking into consideration the number of shares taken up 'firm' by him.

In the examination if nothing is mentioned, the position should be cleared by way of a note.

Students are free to adopt any assumptions in such situation.

For the benefit of the students, Illustration 16 and 17 have been solved assuming that : (a) the benefit of firm underwriting is not given to the underwriter; and (b) the benefit of firm underwriting is given to the underwriter. In our opinion, (a) is much more logical than (b).

Illustration 16

A company made a public issue of 1,25,000 equity shares of ₹ 100 each at par, ₹ 50 payable on application. The entire issue was underwritten by four parties — A, B, C and D in the proportion of 30%, 25%, 25% and 20% respectively. Under the terms agreed upon, a commission of 2% was payable on the amounts underwritten.

A, B, C and D had also agreed on "firm" underwriting of 4,000, 6,000, Nil and 15,000 shares respectively. The total subscription, excluding firm underwriting but including marked applications was for 90,000 shares. Marked applications received were as : A — 24,000; C — 12,000; B — 20,000; and D — 24,000.

Ascertain the liability of the individual Underwriter and also show the journal entries that you would make in the books of company. All working should form part of your answer.

Solution : *If the benefit of firm underwriting is not given to individual underwriter :*

Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	A	B	C	D
Gross liability (A – 30%; B – 25%; C – 25%; D – 20%)	37,500	31,250	31,250	25,000
Less: Marked applications (excluding firm underwriting)	24,000	20,000	12,000	24,000
	13,500	11,250	19,250	1,000
Less: Unmarked applications allotted in the ratio of gross liability (Note 1)	10,500	8,750	8,750	7,000
Resultant liability (or Surplus)	3,000	2,500	10,500	(6,000)
Less: surplus of D allocated to A,B & C in the ratio of gross liability, i.e., 6:5:5	(2,250)	(1,875)	(1,875)	6,000
Net Liability as per agreement	750	625	8,625	Nil
Add: Firm underwriting	4,000	6,000	Nil	15,000
Total liability	4,750	6,625	8,625	15,000

Statement Showing the Amount Due from (due to) Underwriters

Underwriters		A	B	C	D
Number of shares to be subscribed		4,750	6,625	8,625	15,000
Amount payable @ ₹ 50 per share on application	₹	2,37,500	3,31,250	4,31,250	7,50,000
Less: Amount paid on firm application for @ ₹ 50 each		2,00,000	3,00,000	—	7,50,000
Balance payable		37,500	31,250	4,31,250	—
Underwriting commission @ 2% on nominal value of shares underwritten		75,000	62,500	62,500	50,000
Amount paid / received		(37,500)	(31,250)	3,68,750	(50,000)

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
	Bank A/c Dr.	57,50,000	
	To Share Application A/c		57,50,000
	(Being application money received on 1,15,000 shares, 90,000 from public and 25,000 firm application @ ₹ 50 each)		

A A/c Dr.		37,500	
B A/c Dr.		31,250	
C A/c Dr.		4,31,250	
Share Application A/c Dr.		57,50,000	
To Equity Share Capital A/c			62,50,000
(Being allotment of shares to A – 4,750; B – 6,625; C – 8,625; and D – 15,000; application money transferred to Share Capital Account, as per Board's Resolution No. ... dated ...)			
Underwriting Commission A/c Dr.		2,50,000	
To A A/c			75,000
To B A/c			62,500
To C A/c			62,500
To D A/c			50,000
(Being amount payable to A; B; C; and D @ 2% on shares underwritten)			
Bank A/c Dr.		3,68,750	
To C A/c			3,68,750
(Being the balance amount received from C on share application after adjusting underwriting commission)			
A A/c Dr.		37,500	
B A/c Dr.		31,250	
D A/c Dr.		50,000	
To Bank A/c			1,18,750
(Being the amount paid to A, B and D in respect of underwriting commission after adjusting the amount payable on application)			

Tutorial Notes:

(1) Amount payable to A, B and D in respect of underwriting commission can be adjusted against the amount payable on allotment.

(2) For allotment, the entries will be in the usual manner.

Working Notes:

(1) Calculation of unmarked applications

	No.
Total subscriptions (excluding firm underwriting)	90,000
Less: Marked applications (excluding firm underwriting)	80,000
Unmarked applications by public	10,000
Add: Applications under firm underwriting	25,000
Total unmarked applications	35,000

Unmarked applications are allotted in the ratio of gross liability, i.e., 6:5:5:4.

(2) Total allocation of shares

	No.
Unmarked applications by public	10,000
Marked applications by public	80,000
Total liability	35,000
	1,25,000

Alternative Solution: ***If the benefit of firm underwriting is given to individual underwriter :***

Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	A	B	C	D
Gross liability	37,500	31,250	31,250	25,000
Less: Marked applications (excluding firm underwriting)	24,000	20,000	12,000	24,000
	13,500	11,250	19,250	1,000
Less: Unmarked applications (90,000 – 80,000)	3,000	2,500	2,500	2,000
	10,500	8,750	16,750	(1,000)
Less: Firm underwriting	4,000	6,000	—	15,000
	6,500	2,750	16,750	(16,000)
Less: Surplus of D allocated to A, B and C in the ratio of 6:5:5	(6,000)	(5,000)	(5,000)	16,000
	500	(2,250)	11,750	—
Less: Surplus of B allocated to A and C in the ratio of 6:5	(1,227)	2,250	(1,023)	—
	(727)	—	10,727	—
Less: Surplus of A allocated to C	727	—	(727)	—
Net liability as per agreement	—	—	10,000	—
Add: Firm underwriting	4,000	6,000	—	15,000
Total liability	4,000	6,000	10,000	15,000

Statement Showing the Amount Due from (due to) Underwriters

Underwriters		A	B	C	D
Number of shares to be subscribed		4,000	6,000	10,000	15,000
Amount payable @ ₹ 50 per share on application	₹	2,00,000	3,00,000	5,00,000	7,50,000
Less: Amount paid on firm application for @ ₹ 50 per share		2,00,000	3,00,000	—	7,50,000

	—	—	5,00,000	—
Less: Commission @ 2% on nominal value of shares underwritten	75,000	62,500	62,500	50,000
Amount paid / received	(75,000)	(62,500)	4,37,500	(50,000)

Illustration 17

Sardar Ltd. issued to public 1,50,000 equity shares of ₹ 100 at par. ₹ 60 per share was payable along with application and the balance on allotment. The issue was underwritten equally by Ali, Bali and Charlie for a commission of 2.5%. Applications for 1,40,000 shares were received as per detailed below:

Underwriters	Firm application	Marked application	Total
Ali	5,000	40,000	45,000
Bali	5,000	46,000	51,000
Charlie	3,000	34,000	37,000
Unmarked applications			7,000
Total			1,40,000

It was agreed to credit the unmarked applications equally to Ali and Charlie. Sardar Ltd. accordingly made the allotment and received the amount due from public. The underwriters settled their accounts.

You are required to:

(i) Prepare a statement showing the liability of the underwriters and; (ii) journalise the above transactions (including cash) in the book of Sardar Ltd.

Solution ***If the benefit of firm underwriting is not given to individual Underwriters :***

Statement Showing the Liability of Underwriters **[Figures — No. of shares]**

Underwriters	Ali	Bali	Charlie
Gross liability	50,000	50,000	50,000
Less: Marked applications (excluding firm underwriting)	40,000	46,000	34,000
	10,000	4,000	16,000
Less: Unmarked applications allotted in the ratio of gross liability (note 1)	10,000	—	10,000
Net liability as per agreement	—	4,000	6,000
Add: Firm underwriting	5,000	5,000	3,000
Total liability	5,000	9,000	9,000

Statement Showing the Amount Due from (due to) Underwriters

Underwriters		Ali	Bali	Charlie
Number of shares to be subscribed		5,000	9,000	9,000
Amount payable @ ₹ 60 per share on application	₹	3,00,000	5,40,000	5,40,000
Less: Amount paid on firm application @ ₹ 60 each		3,00,000	3,00,000	1,80,000
Balance payable		—	2,40,000	3,60,000
Underwriting commission @ 2.5% on nominal value of shares underwritten		1,25,000	1,25,000	1,25,000
Amount paid / received		(1,25,000)	1,15,000	2,35,000

In the Books of Sardar Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	84,00,000	
	To Share Application A/c			84,00,000
	(Being application money received on 1,40,000 shares, 1,27,000 from public and 13,000 firm application @ ₹ 60 each)			
	Bali A/c (see above statement)	Dr.	2,40,000	
	Charlie A/c	Dr.	3,60,000	
	Share Application A/c	Dr.	84,00,000	
	To Equity Share Capital A/c			90,00,000
	(Being allotment of shares to Ali – 5,000; Bali – 9,000; and Charlie – 9,000; application money transferred to Share Capital Account, as per Board's Resolution No. ... dated ...)			
	Underwriting Commission A/c	Dr.	3,75,000	
	To Ali A/c			1,25,000
	To Bali A/c			1,25,000
	To Charlie A/c			1,25,000
	(Being amount payable to Ali; Bali; Charlie @ 2.5% on shares underwritten)			

Bank A/c	Dr.	3,50,000	
To Bali A/c			1,15,000
To Charlie A/c			2,35,000
(Being the balance amount received from Bali and Charlie on share application after adjusting underwriting commission)			
Ali A/c	Dr.	1,25,000	
To Bank A/c			1,25,000
(Being the amount paid to Ali in respect of underwriting commission after adjusting the amount payable on application)			
Share Allotment A/c	Dr.	60,00,000	
To Equity Share Capital A/c			60,00,000
(Being allotment money due on 1,50,000 shares @ ₹ 40 each as per Board's Resolution No. ... dtd ...)			
Bank A/c	Dr.	60,00,000	
To Share Allotment A/c			60,00,000
(Being allotment money received on 1,50,000 shares @ ₹ 40 each)			

Working Notes:

(1) Calculation of unmarked applications

	No.
Total subscriptions (excluding firm underwriting)	1,27,000
Less: Marked applications (excluding firm underwriting)	1,20,000
Unmarked applications by public	7,000
Add: Applications under firm underwriting	13,000
Total unmarked applications	20,000

(2) Total allocation of shares

	No.
Unmarked applications by public	7,000
Marked applications by public	1,20,000
Total liability	23,000
	1,50,000

Unmarked applications are allotted between Ali and Charlie equally as per terms of agreement.

Tutorial Note: If the benefit of firm underwriting is not given to individual underwriter, the applications for firm underwriting are treated as **unmarked applications**.

Alternative Solution *If the benefit of firm underwriting is given to individual underwriters :*

Statement Showing the Liability of Underwriters

[Figures — No. of shares]

Underwriters	Ali	Bali	Charlie
Gross liability	50,000	50,000	50,000
Less: Marked applications (excluding firm underwriting)	40,000	46,000	34,000
	10,000	4,000	16,000
Less: Unmarked applications allocated between Ali & Charlie equally	3,500	—	3,500
	6,500	4,000	12,500
Less: Firm underwriting	5,000	5,000	3,000
	1,500	(1,000)	9,500
Less: Surplus of Bali allocated to Ali and Charlie in the ratio of 1:1	(500)	1,000	(500)
Net Liability as per agreement	1,000	—	9,000
Add: Firm underwriting	5,000	5,000	3,000
Total liability	6,000	5,000	12,000

Statement Showing the Amount Due from (due to) Underwriters

Underwriters		Ali	Bali	Charlie
Number of shares to be subscribed		6,000	5,000	12,000
Amount payable @ ₹ 60 per share on application	₹	3,60,000	3,00,000	7,20,000
Less: Amount paid on firm application		3,00,000	3,00,000	1,80,000
		60,000	—	5,40,000
Less: Underwriting commission @ 2.5% on nominal value of shares underwritten		1,25,000	1,25,000	1,25,000
Amount paid / received		(65,000)	(1,25,000)	4,15,000

2(a) When the issue is partially underwritten [without firm underwriting]

In case of partial underwriting, the company is treated as having underwritten the remaining shares. The unmarked applications are treated as marked so far as the company is concerned. No credit is given to the underwriter for unmarked applications.

If the partial underwriting is done by one underwriter only, the determination of liability is very simple. In this case, the following steps are followed:

Step 1 Calculate gross liability as per agreement.

Step 2 Deduct the marked applications. The balance is treated as ***net liability***.

In this case no credit is given to the underwriter for "***unmarked***" applications.

Illustration 18

X Ltd. issued 1,00,000 equity shares of ₹ 10 each at par. A & Co. agreed to underwrite 80% of the whole issue.

Applications were received for 70,000 shares out of which applications for 50,000 shares were marked. Determine the net liability of A & Co.

Solution **Statement Showing the Net Liability**

Particulars	No.
Gross liability (80% of 1,00,000)	80,000
Less: Marked applications	50,000
Net liability	30,000

Tutorial Notes:

(1) If the company received applications for 1,00,000 shares or more, the underwriter's liability would be nil even if the marked applications were *less than the gross liability*.

(2) If the company received applications for more than ***gross liability***, the underwriter's liability = Total number of shares issued (*less* number of shares subscribed). In the above example, if the company received applications for 90,000 shares, the net liability of A & Co will be: 1,00,000 – 90,000 = 10,000 shares.

(3) In the examination, if no information is given regarding marked and unmarked applications, the students may follow the following formula for finding out the number of marked applications:

Marked applications = Total number of applications received x percentage of underwriting.

In the above example, if no details are given, the number of marked applications can be calculated as follows:

Marked applications = 70,000 x 80% = 56,000

If the partial underwriting is done by more than one underwriter, the net liability of each underwriter can be calculated as follows:

Step 1 Calculate gross liability of each Underwriter in the agreed ratio.

Step 2 Deduct the marked applications of each underwriter from their respective gross liability.

The balance is treated as ***net liability***.

Illustration 19

Narmada Ltd., incorporated on 1st January, 2015, issued a prospectus inviting applications for 1,00,000 equity shares of ₹ 10 each. The issue was partially underwritten by A, B and C as follows: A — 40%; B — 30%; C — 20%.

Applications were received for 80,000 shares of which marked applications were as follows: A — 35,000 shares; B — 26,000 shares; C — 14,000 shares. You are required to find out the liabilities of individual Underwriters.

Solution **Statement Showing the Liability of Underwriters**

Underwriters	A (40%)	B (30%)	C (20%)
Gross liability (shares)	40,000	30,000	20,000
Less: Marked applications	35,000	26,000	14,000
Net liability	5,000	4,000	6,000

Illustration 20

X Ltd. issued 10,000 shares of ₹ 100 each at a premium of ₹ 15 each. 90% of the issue was underwritten by M/s Broker and Co. at a commission of 1% on the nominal face value. Applications were received for 8,000 shares and allotment was fully made. All the amount due from allottees was received in one instalment. The accounts with Broker & Co. were settled. Show the Journal entries to record the transaction.

In the Books of X Limited
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	9,20,000	
	To Share Application A/c			9,20,000
	(Being application money received on 8,000 shares @ ₹ 115 each)			
	Share Application A/c	Dr.	9,20,000	
	To Share Capital A/c			8,00,000
	To Securities Premium A/c			1,20,000
	(Being transfer of amount received on 8,000 shares to Capital Account and Securities Premium Account @ ₹ 100 and ₹ 15 respectively as per Board's Resolution No. ... dated ...)			
	M/s Broker & Co A/c	Dr.	2,07,000	
	To Share Capital A/c			1,80,000
	To Securities Premium A/c			27,000
	(Being amount due from M/s Broker & Co for 1,800 shares taken up as per underwriting agreement)			
	Underwriting Commission A/c	Dr.	9,000	
	To M/s Broker & Co A/c			9,000
	(Being commission payable @ 1% on 9,000 shares of ₹ 100)			
	Bank A/c	Dr.	1,98,000	
	To M/s Broker & Co A/c			1,98,000
	(Being the balance money received from M/s Broker & Co)			

Working Notes: **Calculation of Net Liability of M/s Broker & Co.**

Particulars	No.
Gross liability (90% of 1,00,000)	9,000
Less: marked applications (90% of 8,000*)	7,200
Net liability	1,800

Tutorial Note : If no information is given regarding marked and unmarked applications, the students may follow the following formula for finding out "marked" applications.
*Marked Applications = Total applications x percentage of underwriting

2 (b) When the issue is partially underwritten [with firm underwriting]

In this case calculate the ***net liability*** of each underwriter in the usual manner and thereafter add firm underwriting to get the ***total liability***.

Illustration 21

A entered into an underwriting agreement with B Ltd. for 60% of the issue of 15% ₹ 50,00,000 debentures with a firm underwriting of ₹ 5,00,000. Marked applications were for ₹ 35,00,000 debentures. Calculate the liability of the underwriter and the commission payable to him.

Solution

A's liability is limited to 60% of ₹ 50,00,000 i.e., ₹ 30,00,000. Marked applications were received for ₹ 35,00,000. The issue is oversubscribed but there is a firm underwriting. Therefore, the liability of the underwriter is limited to the extent of firm underwriting i.e., ₹ 5,00,000. Commission is payable @ 2-1/2% of issue price. Therefore, the amount of commission will be = 2-1/2% of ₹ 30,00,000 = ₹ 75,000 (assuming that debentures were issued at par).

KEY POINTS

- Underwriting is an agreement, with or without conditions, to subscribe to the securities of an issuer when existing shareholders of the issuer or the public do not subscribe to the securities offered to them.
- The rate of commission paid or agreed to be paid shall not exceed, in case of shares, ***five percent*** of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed ***two and a half per cent*** of the price at which the debentures are issued, or as specified in the company's articles, whichever is less.
- The Companies (Meetings of Board and its Powers) Rules, 2014 states that : "A company having paid-up capital of ₹ 10 crore rupees or more shall not pay underwriting commission more than 1% without proper approval of the company by a special resolution."
- There are two types of underwriting agreement : (a) conditional; and (b) firm.
  - ¤ **Conditional underwriting** : Under this type of agreement, the underwriter agrees to take up agreed proportion of shares, not taken up by the public. If the shares are fully subscribed by the public, the underwriter does not take up any share.
  - ¤ **Firm underwriting** : Under this type of agreement, the underwriter agrees to take up a specified number of shares irrespective of the number of shares subscribed for by the public. Unless it has otherwise agreed, the underwriters' liability is determined without considering the number of shares taken up 'firm' by him.

KEY POINTS (contd. ...)

- 'Marked' applications are those applications which bear the stamp of an underwriter. If the issue is not fully subscribed, 'marked' applications shall be applied in reduction of underwriter's liability.
- The 'unmarked' applications are those applications which bear no stamp of an underwriter. These applications are received by the company directly from the public.
- Unless it has been otherwise agreed, the underwriters' liability is to be determined without taking into consideration the number of shares taken up 'firm' by him.
- In the examination if nothing is mentioned, the position should be cleared by way of a note. Students are free to adopt any assumptions in such situation.

THEORETICAL QUESTIONS

1. What do you understand by underwriting?
2. State the restrictions and conditions placed under Companies Act, 2013 for appointment of underwriters.
3. Write a short note on: Firm Underwriting and Partial Underwriting along with Firm Underwriting.
4. What do you understand by "firm" underwriting ? Pass the accounting entries relating to firm underwriting in the books : (i) the company; (ii) the underwriter.
5. State the conditions for payment of underwriting commission as per the Companies (Prospectus and Allotment of Securities) Rules, 2014.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. The payment of commission to underwriter(s) is to be authorised by
   A the board of directors
   B the articles of association
   C the memorandum of association
   D Ministry of Corporate Affairs
2. A merchant banker can act as a underwriter provided he holds a certificate granted by
   A Government of India
   B Company Law Board
   C SEBI
   D Registrar of Companies
3. In respect of every underwritten issue, the merchant banker(s) shall undertake a minimum obligation of
   A 5% of the total underwriting commitment or ₹ 35 lacs whichever is less
   B 10% of the total underwriting commitment or ₹ 20 lacs whichever is less
   C 5% of the total underwriting commitment or ₹ 25 lacs whichever is less.
   D 10% of the total underwriting commitment or ₹ 25 lacs whichever is less.
4. As per the provision of the Companies Act, 2013, in case of shares, the commission paid or agreed to be paid does not exceed
   A 2% of the issue price
   B 2.5% of face value
   C 5% of face value
   D 5% of the issue price
5. As per the provision of the Companies Act, 2013, in case of debentures, the commission paid or agreed to be paid does not exceed
   A 2% of the face value
   B 2.5% of the issue price
   C 5% of the issue price
   D 2% of the issue price

PRACTICAL QUESTIONS

1. Super India Ltd issued 75,000 equity shares. The whole of the issue was underwritten as follows : A — 50%; B — 25%; C — 25%. Applications for 60,000 shares were received in all, out of which applications for 15,000 shares had the stamp A, those for 7,500 shares that of B, and those for 15,000 shares that of C. The remaining applications for 22,500 shares did not bear any stamp. Determine the liability of the underwriters.

2. M Ltd has authorised capital of ₹ 50,00,000 divided into 1,00,000 equity shares of ₹ 50 each. The company issued for subscription 50,000 shares at a premium of ₹ 10 each. The entire issue was underwritten as follows : A — 30,000 shares (firm underwriting — 5,000 shares); B — 15,000 shares (firm underwriting — 2,000 shares); and C — 5,000 shares (firm underwriting — 500 shares). Out of the total issue, 45,000 shares including firm underwriting were subscribed. The following were the marked forms : A — 16,000 shares; B — 10,000 shares; C — 4,000 shares. Calculate the liability of each underwriter.
3. Gamma Ltd. issued 25,00,000 equity shares of ₹ 10 each at par. The issue was fully underwritten by Alpha — 40%; Beta — 40%; and Zeta — 20%. Applications were received for 24,00,000 equity shares. The marking on the applications were as: Alpha — 13,00,000 shares; Beta — 7,00,000 shares; Zeta — 2,50,000 shares.
The under-subscription of 1,00,000 shares will be taken up as: (a) Alpha — 40,000; Beta — 40,000; Zeta — 20,000; (b) Alpha — Nil; Beta — Nil; Zeta — 1,00,000; (c) Alpha — 33,334; Beta — 33,333; Zeta — 33,333; (d) Alpha — 1,00,000; Beta — Nil; Zeta — Nil; (e) None of the above.
4. Ceeta Ltd. issued 25,00,000 equity shares of ₹ 10 each at par. The issue was underwritten by A, B and C as : A — 30%; B — 30%; and C — 40%. Applications were received for 23,00,000 equity shares. The marked applications were as: A — 3,50,000; B — 4,00,000; and C — 13,50,000. The under-subscription of 2,00,000 equity shares will be taken up as: (a) A — 75,000; B — 1,25,000; C — Nil; (b) A — Nil; B — 75,000; C — 1,25,000; (c) A — 1,25,000; B — Nil; C — 75,000; (d) A — 1,25,000; B — 75,000; C — Nil; (e) None of the above.
5. Janta Ltd. issued 40,000 shares which were underwritten as: A — 24,000 shares; B — 10,000 shares; and C — 6,000. The underwriters made applications for firm underwriting as under: A : 3,200 shares; B : 1,200 shares; and C : 4,000 shares. The total subscription excluding firm underwriting but including marked application was for 20,000. The marked applications were as: A — 4,000 shares; B — 8,000 shares; and C — 2,000 shares.
Show the allocation of liability of underwriters.
6. Swiss Ltd. issued 40,000 equity shares of ₹ 10 each at par. The entire issue was underwritten as follows:
A — 24,000 shares (firm underwriting 3,200 shares); B — 10,000 shares (firm underwriting 4,000 shares); and C — 6,000 shares (firm underwriting 1,200 shares)
The total applications including firm underwriting were for 28,400 shares. The marked applications were as : A — 7,200 shares; B — 9,000 shares; and C — 3,200 shares. The underwriting contract provides that credit for unmarked applications be given to the underwriters in proportion to the shares underwritten. Determine the liability of each underwriter and the amount of commission payable to them assuming it is the maximum allowed by law.
7. X Co. Ltd. was formed with a capital of ₹ 10,00,000 in ₹ 10 shares, the whole amount being issued to the public. The underwriting of these shares was as follows: M : 35,000; N : 30,000; O : 20,000; P : 10,000; Q : 3,000; and R : 2,000. All the marked application forms were to go in relief of the underwriters whose names they carried. The application forms marked by the Underwriters were: M—10,000; N—22,500; O—20,000; P—7,500; Q—5,000; and R—Nil. Applications for 20,000 shares were received on forms not marked. Dr.aw up a statement showing the number of shares each underwriter had to take up.
8. Plentiful Ltd. comes out with a public issue of share capital on 1.1.2017 of 10,00,000 equity shares of ₹ 10 each at a premium of 5%. ₹ 2.50 is payable on application (on or before 31.1.2017) and ₹ 3.00 on allotment (31.3.2017) including premium. The issue is underwritten by two underwriters — Seth and Shetty, equally, the commission being 5% of the issue price. Each of the Underwriters underwrites 20,000 shares firm.
Subscriptions total 9,60,000 shares, the distribution of forms being: Seth : 5,20,000; Shetty : 3,60,000 and unmarked forms 80,000. One of the allottees (using forms marked with name of Seth) for 2,000 shares, fails to pay the amount due to allotment, all other money due being received in full including any due from the shares devolving upon the underwriters. The commission due is paid separately.
The shares of the indifferent allottee are finally forfeited by 30.6.2017 and are re-allotted for payment in cash of ₹ 4 per share. You are required to pass summary journal entries to record the above events and transactions (including cash).

Guide to Answers

Multiple Choice

1. B; 2. C; 3. C; 4. D; 5. B.

Practical Questions

1. Net Liability — A : ₹ 10,000; and B : ₹ 5,000. **2. Total Liability — A : ₹ 9,667; B : ₹ 2,333; C : ₹ 500.**
3. (b) Liability is to be met by Zeta ₹ 1,00,000. **4. (d) Liability is to be met by A — 1,25,000 shares; and B — 75,000 shares.**
5. Total liability : A — 13,280 shares; B — 1,200 shares; and C — 5,520 shares.
6. Total liability : A — 13,600 shares; B — 4,000 shares; and C — 2,400 shares.
7. Liability is to be met by : M — 13,649 shares; R — 1,351 shares; and N, O P and Q — Nil.
8. Liability is to be met by Shetty — 40,000 shares excluding firm underwriting.

14

Profit or Loss Prior to Incorporation

Introduction

In many cases, a new company is formed exclusively to acquire an existing business unit and take it over as a going concern, from a date prior to its ***own incorporation***. In such cases, the business unit is purchased first, and the registration of the acquiring company takes place later. ***For example***, Sarvottam Pvt. Ltd. is incorporated on 1st April, 2017 to take over the running business of Uttam Bros. from 1st January, 2017. The profit earned (or loss suffered) during the pre-incorporation period (in our example: 1st January to 31st March 2017) is called ***profit (loss) prior to incorporation***. Legally, this profit is not available for distribution as dividend, since a company cannot earn profit before it comes into existence. However, profit earned after incorporation is available for distribution as dividend. Profit earned before incorporation is a ***capital profit*** and profit earned after incorporation is a ***revenue profit***.

After incorporation, a public limited company is required to obtain a certificate of commencement of business. Here, the question may arise as to whether the pre-acquisition profit to be calculated based on the date of incorporation or date of obtaining certificate of commencement ?

It is a common practice that the date of incorporation should be taken as the basis for calculation of pre-acquisition profit since obtaining a certificate of commencement of business is purely a legal formality.

The accounting treatment of pre-incorporation profit (or loss) is totally different from Post-incorporation profit (or loss). Thus, it is necessary to compute both the amount of pre- and post-incorporation profit (loss).

Methods of Computing Profit Prior to Incorporation

There are different methods of computing profit prior to incorporation. They are:

First Method

Under this method, a separate Profit and Loss Account is prepared for the pre-incorporation period as distinguished from Profit and Loss Account for post-incorporation period. On the incorporation date, stock is taken, a Final Account is prepared, and the old books of account are closed. This method of profit determination, though simple and accurate, is inconvenient and expensive because the business activities have to be suspended for a few days for stock taking.

For the above reasons, this method is not generally followed in practice. In the books of the new company, acquisition entries are passed on the same date after taking into consideration the assets and liabilities on the date of incorporation, which thus would include the results ***up to that date***.

The entries are:

(i) Land and Building Account	Dr.	At the value on the date of incorporation
Plant and Machinery Account	Dr.	
Sundry Debtors Account	Dr.	
Stock Account	Dr.	
Cash at Bank	Dr.	
Cash in Hand	Dr.	
To Liabilities Account		At the value on the date of incorporation
To Vendors Account		Purchase consideration
(ii) Vendors Account	Dr.	
To Equity Share Capital Account		

Second Method

Under this method profit is calculated as follows:

Step 1 Prepare a Trading Account for the entire period (pre- and post-incorporation periods combined).

Step 2 Allocate gross profit and expenses (indirect) between pre- and post-incorporation period on the basis of the following principles:

(i) Gross profit is allocated in the ***ratio of sales*** of each period.

(ii) Fixed portion of an expense is allocated on ***the basis of time***.

(iii) Expenses related to sales, e.g., traveller's commission, discount allowed; advertisement; salaries of salesmen; carriage outward; after-sales service cost, etc, are allocated on ***the basis of sales***.

(iv) Expenses related to time, e.g., rent, rates and taxes; insurance; depreciation, salaries of general staff, etc. are allocated on ***the basis of time***.

(v) Expenses which are exclusively related to pre- or post-incorporation period must be charged entirely to that period's profit. Some examples are:

(a) Preliminary expenses, director's fees, debenture interest, etc are to be charged against post-incorporation profit.

(b) Partner's salaries, interest on partners' capital, etc are to be charged against the profit of pre-incorporation period.

Students should remember the following for ready reference :

	List of Expenses which are Allocated in Ratio of Sales		List of Expenses which are Allocated on Basis of Time
1.	Gross Profit	1.	Rent, Rates and Taxes
2.	Bad Debts	2.	Depreciation
3.	Discount Allowed	3.	Salaries of General Staff
4.	Carriage Outwards	4.	Insurance
5.	Selling Expenses	5.	Interest on Purchase Consideration
6.	Salesmen's Commission	6.	Audit Fees
7.	Advertisement Expenses	7.	General Expenses

8.	Delivery Expenses	8.	Printing and Stationery
9.	Free Samples	9.	Office Expenses
10.	After-sales service cost	10.	Fixed Expenses
11.	Salaries of Salesmen	11.	Miscellaneous Expenses
12.	Sales Promotion Expenses	12.	Fixed Distribution Expenses
13.	Variable Distribution Expenses	13.	Administrative Expenses
		14.	General Travelling Expenses

Step 3 Net profit/loss of respective periods are calculated after deducting apportioned expenses and acquisition entries are passed at the ***end of the accounting year***.

Accounting Treatment of Pre-incorporation Profit/Loss

Profit Prior to Incorporation

Any profit prior to incorporation may be dealt with as follows:

(a) Credited to Capital Reserve Account
(b) Credited to Goodwill Account to reduce the amount of goodwill arising from acquisition of business.
(c) Utilised to write down the value of fixed assets acquired.

Loss Prior to Incorporation

Any loss prior to incorporation may be dealt with as follows:

(a) Debited to Goodwill Account
(b) Debited to Capital Reserve Account arising from acquisition of business.
(c) Debited to a Suspense Account, which can be written-off later as a fictitious asset.

Accounting Treatment of Post-incorporation Profit/Loss

Any profit / loss after incorporation is transferred to Profit and Loss Appropriation Account. Post-incorporation profit can be distributed as dividend.

Illustration 1

Star Ltd was incorporated on 1st July, 2016 to acquire a running business with effect from 1st April, 2016. The accounts for the year ended 31st March, 2017 disclosed the following :

(i) There was a gross profit of ₹ 3,00,000.
(ii) The sales for the year amounted to ₹ 12,00,000 of which ₹ 2,40,000 were for the first six months.
(iii) The expenses debited to the Profit and Loss Account included — directors' fees : ₹ 15,000; bad debts : ₹ 3,600; advertising : ₹ 12,000 (under a contract amounting to ₹ 1,000 per month); salaries and general expenses : ₹ 64,000; preliminary expenses written off ₹ 5,000; and donation to a political party given by the company ₹ 5,000.

Prepare a statement showing the amount of profit made before and after incorporation.

Solution

Star Ltd.

Statement Showing Apportionment of Profit between Pre- and Post- incorporation Period

Particulars	Notes	Basis	Total ₹	Pre-incorporation 1.4.2016 to 30.6.2016 (3 months)	Post-incorporation 1.7.2016 to 31.3.2017 (9 months)
Gross Profit (A)	1	Sales (1:9)	3,00,000	30,000	2,70,000
Less : **Expenses** (B)					
Bad Debts		Sales (1:9)	3,600	360	3,240
Advertising		Direct	12,000	3,000	9,000
Salaries and General Expenses	2	Time (1:3)	64,000	16,000	48,000
Director's Fees	3	Direct	15,000	—	15,000
			94,600	19,360	75,240

Net Profit (A – B)		2,05,400	10,640	1,94,760
Less: **Appropriations** :				
Preliminary Expenses (Note 4)	5,000			
Donation (Note 4)	5,000	10,000	—	10,000
		1,95,400	10,640	1,84,760
			Capital Profit	Net Profit

Tutorial Note : Capital profit is transferred to **Capital Reserve Account** and Net profit is transferred to **Statement of Profit and Loss**.

Working Notes :

(1) Total sales for the year 2016-17 = ₹ 12,00,000. Sales for the first 6 months (1.4.2016 to 30.9.2016) = ₹ 2,40,000. Therefore, sales per month during first 6 months = ₹ 2,40,000 / 6 = ₹ 40,000.

In effect, sales of first three months (1.4.2016 to 30.6.2016) = ₹ 40,000 × 3 = ₹ 1,20,000.

Sales of next nine months (1.7.2016 to 31.3.2017) = ₹ 12,00,000 – ₹ 1,20,000 = ₹ 10,80,000.

Ratio of Sales = 1,20,000 : 10,80,000 = 1 : 9. It is assumed that sales are evenly occurred during first six months.

(2) These expenses generally accrue evenly throughout the year and are, therefore, divided on the ***time basis***, i.e., 3 : 9 or 1 : 3.

(3) Directors' fees are paid in case of company only. These must naturally be shown in the post-incorporation period.

(4) Preliminary expenses and donation are not charges against profit. These are treated as appropriations.

Illustration 2

The promoters of proposed New Wave Ltd. purchased a running business on 1st January, 2016 from Mr. Ultra Modern. New Wave Ltd was incorporated on 1st May, 2016. The combined Profit and Loss Account of the company prior to and after the date of incorporation is as under:

Profit & Loss Account for the year ended on 31.12.2016

	₹		₹
To Rent, rates, insurance, electricity & salaries	12,000	By Gross profit	1,50,000
To Directors' sitting fees	3,600	By Discount received from creditors	6,000
To Preliminary expenses	4,900		
To Carriage outwards and selling expenses	5,500		
To Interest paid to Vendors	10,000		
To Profit	1,20,000		
	1,56,000		1,56,000

Following further information is available:

(1) Sales up to 30.4.2016 were ₹ 3,00,000 out of total sales of ₹ 15,00,000 of the year.

(2) Purchases up to 30.4.2016 were ₹ 300,000 out of total purchases of ₹ 9,00,000 of the year.

(3) Interest paid to Vendors on 1.11.2016 @ 12% p.a on ₹ 1,00,000 being purchase consideration.

From the above information, prepare Profit and Loss Account for the year ended 31st December, 2016, showing the profit earned prior to and after incorporation and also show the transfer of the same to the appropriate accounts.

Solution

New Wave Ltd.

Statement of Profit and Loss for the year ended 31st December, 2016

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit	(1)	1,50,000	30,000	1,20,000
Discount Received	(7)	6,000	2,000	4,000
Total (A)		1,56,000	32,000	1,24,000
Less: Expenses (B)				
Rent, Rates and Insurance, Electricity and Salaries	(2)	12,000	4,000	8,000
Directors' Sitting Fees	(3)	3,600	—	3,600
Preliminary Expenses	(4)	4,900	—	4,900
Carriage Outward	(5)	5,500	1,100	4,400
Interest o Vendor	(6)	10,000	4,000	6,000
		36,000	9,100	26,900
Net Profit (A – B)		1,20,000	22,900 Capital Profit	97,100 Revenue Profit
Transferred to			Capital Reserve	Statement of Profit and Loss

Working Notes:

(1) For 4 months to 30th April, sales amounted to ₹ 3,00,000 and for the remaining 8 months, sales were (₹ 15,00,000 - ₹ 3,00,000) ₹ 12,00,000. Gross profit is apportioned in the ratio of 3:12 or 1:4 (assuming the gross rate was uniform throughout the year).

Therefore, the gross profit is apportioned as: Pre — $\frac{1,50,000}{5} \times 1 =$ ₹ 30,000. Post — $\frac{1,50,000}{5} \times 4 =$ ₹ 1,20,000.

(2) These expenses generally accrue evenly throughout the year and are therefore divided on the time basis, pre:post 4 months : 8 months or 1:2.

(3) Directors' sitting fees and preliminary expenses are generally found in case companies. These must naturally be shown in post-incorporation period.

(4) Strictly, to Appropriation Account. Alternatively, it can be written off against post-incorporation profit.

(5) Carriage outward has been apportioned in the ratio of sales, i.e.

Pre — $\frac{5,500}{5} \times 1 =$ ₹ 1,100 Post — $\frac{5,500}{5} \times 4 =$ ₹ 4,400

(6) Interest accrues on the basis of time. Therefore it is divided on the time basis. Interest has been paid for a total of 10 months (January to October). 4 months related to pre-incorporation period and 6 months to post-incorporation period. Therefore, it is split as:

Pre — $\frac{10,000}{10} \times 4 =$ ₹ 4,000 Post — $\frac{10,000}{10} \times 6 =$ ₹ 6,000

(7) For 4 months to 30th April, purchases amounted to ₹ 3,00,000 and for the remaining 8 months, purchases were: (₹ 9,00,000 - 3,00,000) = ₹ 6,00,000.

Discount received is apportioned in the ratio of 3:6 or 1:2. Therefore discount received is apportioned as:

Pre — $\frac{6,000}{3} \times 1 =$ ₹ 2,000. Post — $\frac{6,000}{3} \times 2 =$ ₹ 4,000.

Illustration 3

From the following information, calculate the ratio of Sales in each case separately.

(a) (i) Date of acquisition — 1st April, 2016; date of incorporation — 1st July, 2016 and date of closing the books of accounts — 31st March, every year.

(ii) The sales for the year ending on 31st March, 2017 were ₹ 24,00,000 of which ₹ 4,80,000 were sold during the first six months of the accounting period.

(b) (i) The accounts were made up to 31st December, 2016. The company was incorporated on 1st May, 2016 to take over a business from the preceding 1st January.

(ii) Total sales for the year were ₹ 12,00,000. It is ascertained that the sales for November and December are one and half times the average of those for the year, whilst those for February and April are only half the average.

(c) (i) X Ltd. was incorporated on 1st July, 2016 to take the existing business of X from 1st April, 2016. Date of closing the books of account — 31st March, 2017.

(ii) Monthly sales in April 2016, February 2017 and March 2017 are double the average monthly sales for remaining months of the year.

(d) (i) S. Ltd. was incorporated on 1st August, 2016, to take over the running business of Kabir Bros. with effect from 1st April, 2016. The company received the certificate of commencement of business on 1st October, 2016.

(ii) Total sales for the year, which amounted to ₹ 16,00,000 arose evenly upon the date of certificate of commencement, whereafter they recorded an increase of 2/3rd during the remaining period.

Solution

(a) Sales of first 6 months = ₹ 4,80,000. Average sale of first 6 months = ₹ 4,80,000 / 6 = ₹ 80,000 per month.

Pre-incorporation period consist of 3 months (i.e., April, May and June). The sales of those 3 months = ₹ 80,000 × 3 = ₹ 2,40,000. Sales of remaining 9 months = ₹ 24,00,000 – ₹ 2,40,000 = ₹ 21,60,000.

Therefore, the ratio of sales = ₹ 2,40,000 : ₹ 21,60,000 or 1 : 9.

(b) Let the average of monthly sales = x. The sales of different months can be shown as follows :

Month	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec
Sales	1x	0.5x	1x	0.5x	1x	1x	1x	1x	1x	1x	1.5x	1.5x

Date of incorporation

The ratio of Sales = $3x : 9x$ or 1 : 3.

(c) Let the average monthly sales be x. The sales of different months can be shown as follows:

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	2x	1x	1x	1x	1x	1x	1x	1x	1x	1x	2x	2x

Date of incorporation

The ratio of sales = $4x : 11x$ or 4 : 11.

(d) Let the average monthly sales = x. The sales of different months can be shown as follows :

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	1x	1x	1x	1x	1x	1x	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$

Date of incorporation Certificate of commencement

The ratio of sales = $4x : 12x$ or 1 : 3.

Illustration 4

A firm which was carrying on business from 1st January, 2016 gets itself incorporated as a company on 1st May, 2016. The first accounts are drawn up to 30th September, 2016. The gross profit for the period is ₹ 56,000. The general expenses are ₹ 14,220; directors' fees ₹ 12,000 p.a.; formation expenses ₹, 1,500. Rent up to 30th June is ₹ 1,200 p.a., after which it is increased to ₹ 3,000 per annum. Salary of the manager, who upon incorporation of the company was made a director, is ₹ 6,000 p.a. His remuneration thereafter is included in the above figure of fees to directors.

Give Profit and Loss Account showing pre-and post-incorporation profits. The net sales are ₹ 8,20,000, the monthly average of which for the first four months of 2016 is one half of that of the remaining period. the company earned a uniform profit. Interest and tax may be ignored.

Solution Statement of Profit and Loss for 9 months ended on 30th September, 2016

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit (A)	(1)	56,000	16,000	40,000
Less : Expenses (B) :				
General Expenses	(2)	14,220	6,320	7,900
Directors' Fees	(3)	5,000	—	5,000
Formation Expenses	(4)	1,500	—	1,500
Rent	(5)	1,350	400	950
Manager's Salary	(6)	2,000	2,000	—
		24,070	8,720	15,350
Net Profit (A – B)			7,280 Capital Profit	24,650 Revenue Profit
Transferred to			Capital Reserve	Statement of Profit and Loss

Working Notes:

(1) Let the average monthly sales of first four months be ₹ 100. Then the average monthly sales of next five months will be ₹ 200. Total sales of first four months = ₹ 100 x 4 = ₹ 400 and that of next five months = ₹ 200 x 5 = ₹ 1,000. The ratio of sales = 400:1000 or 2:5.

The gross profit is apportioned on the basis of sales, i.e. 2:5. Therefore, the gross profit is apportioned as:

Pre — $\frac{56,000}{7} \times 2$ = ₹ 16,000 Post — $\frac{56,000}{7} \times 5$ = ₹ 40,000.

(2) General expenses accrue evenly throughout the period and are, therefore, divided on the basis of time.

Pre — $\frac{14,220}{9} \times 4$ = ₹ 6,320 Post — $\frac{14,220}{9} \times 5$ = ₹ 7,900.

(3) Directors' fees payable @ ₹ 1,000 per month. It is to be found in company only.

So ₹ 5,000 (5 x ₹ 1,000) must naturally be shown in post-period incorporation period.

(4) Strictly, to Appropriation Account. Alternatively, it can be written-off against pre-incorporation profit.
(5) Rent for first four months = ₹ 100 x 4 = ₹ 400. For next five months = (₹ 100 x 2) + (₹ 250 x 3) = ₹ 950.
(6) Salary to manger is related to pre-incorporation period only. Salary to be charged = ₹ 500 x 4 = ₹ 2,000.

Illustration 5

Star Pvt. Ltd. was incorporated on 1st March, 2016 to acquire a running business with effect from 1st January, 2016. The purchase consideration was agreed at ₹ 90,000 to be satisfied by issue of :

3,000 equity shares of ₹ 10 each fully paid-up and ₹ 60,000, 8% Debentures.

The following Profit and Loss Account for the year ended 31st December, 2016 is presented to you :

Particulars	₹	Particulars	₹
Staff Salary	12,000	Gross Profit	80,000
Selling and Distribution Expenses	6,000		
Rent and Rates	4,200		
Debenture Interest	3,600		
Bad Debt (there was no cash sales)	1,000		
Preliminary Expenses	25,000		
Interest on Purchase Consideration	2,250		
Balance	25,950		
	80,000		80,000

You obtain the following additional information :

(i) Sales for the year was ₹ 4,00,000, whereas sales incurred by the Company after incorporation was ₹ 3,00,000.
(ii) The shares and 8% Debentures were issued to the Vendor on 1st April, 2016.
(iii) Interest at 10% per annum was paid on the purchase consideration from 1st January, 2016 to the date of payment.

Prepare a Statement showing the amount of profit made before and after incorporation.

Solution

Star Pvt. Ltd.
Statement of Profit and Loss for the year ended 31st December, 2016

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit (A)	(1)	80,000	20,000	60,000
Less : Expenses (B) :				
Staff Salary	(2)	12,000	2,000	10,000
Selling and Distribution Expenses	(3)	6,000	1,500	4,500
Rent and Rates	(4)	4,200	700	3,500
Debenture Interest	(5)	3,600	—	3,600
Bad Debts	(6)	1,000	250	750
Preliminary Expenses		25,000	—	25,000
Interest on Purchase Consideration		2,250	1.500	750
		54,050	5,950	48,100
Net Profit (A – B)		25,950	14,050 Capital Profit	11,900 Revenue Profit
Transferred to			Capital Reserve	Statement of Profit and Loss

Working Notes :

(1) Total sales for the year = ₹ 4,00,000. Post-incorporation sales = ₹ 3,00,000. Therefore, pre-incorporation profit = ₹ 4,00,000 – 3,00,000 = ₹ 1,00,000.
Ratio of sales between pre-incorporation period and post-incorporation period = 1,00,000 : 3,00,000 = 1 : 3.
The gross profit is apportion on the basis of sales, i.e., 1 : 3. Therefore, gross profit is apportioned as :

Pre — $\frac{80,000}{4} \times 1$ = ₹ 20,000; Post — $\frac{80,000}{4} \times 3$ = ₹ 60,000

(2) Staff salary is divided on the basis of time :

Pre — $\frac{12,000}{12} \times 2$ = ₹ 2,000 Post — $\frac{12,000}{12} \times 10$ = ₹ 10,000

(3) Selling and distribution expenses are divided in the ratio of sales, i.e., 1 : 3.

$$\text{Pre} — \frac{6{,}000}{4} \times 1 = ₹\ 1{,}500 \qquad \text{Post} — \frac{6{,}000}{4} \times 3 = ₹\ 4{,}500$$

(4) Rent and rates are divided in the ratio of time, i.e., 2 : 10

$$\text{Pre} — \frac{4{,}200}{12} \times 2 = ₹\ 700 \qquad \text{Post} — \frac{4{,}200}{12} \times 10 = ₹\ 3{,}500$$

(5) Debenture interest is related to post-incorporation period.

(6) Bad Debts are related to sales. Therefore, bad debts are to be divided in the ratio of sales, i.e., 1 : 3.

$$\text{Pre} — \frac{1{,}000}{4} \times 1 = ₹\ 250 \qquad \text{Post} — \frac{1{,}000}{4} \times 3 = ₹\ 750.$$

(7) Interest on Purchase Consideration is payable for 3 months (1st January to 31st March). Total Interest = ₹ 90,000 × 10% × 3/12 = ₹ 2,250.

Pre-incorporation period's Interest = 2,250 / 3 × 2 = 1,500; **Post-incorporation period's Interest** = ₹ 2,250 / 3 × 1 = 750

Illustration 6

Mr. X formed a private limited company under the name and style of Exe Pvt. Ltd. to take over his existing business as from first April 2016, but the company was not incorporated until First July 2016.

No entries relating to transfer of the business were entered in the books, which were carried on without a break till 31st March, 2017.

The following balances were extracted from the books as on 31st March, 2017.

Heads of Account	Dr.	Cr.
Opening Stock	43,000	
Purchases	1,89,000	
Carriage Outwards	3,300	
Travellers' Commission	7,500	
Office Salaries	21,000	
Administration expenses	19,900	
Rent and Rates	12,000	
Director's fee	18,000	
Fixed assets	1,00,000	
Current Assets excluding stock	34,000	
Preliminary expenses	5,200	
Sales		2,78,000
Mr X's capital A/c on 1.4.2016		2,30,000
Current Liabilities		37,000

You are also given that:

(a) Stock on 31st March, 2017, ₹ 44,000.

(b) The gross profit ratio is constant and monthly sales in April 2016, February 2017 and March 2017 are double the average monthly sales for remaining months of the year.

(c) The purchase consideration was agreed to be satisfied by the issue of 3,000 equity shares of ₹ 100 each.

(d) The preliminary expenses are to be written off.

(e) You are to assume that carriage outwards and travellers' commission vary in direct proportion to sales.

You are required to prepare Profit and Loss Account for the year ended on 31st March, 2017, apportioning the profit or loss of the periods before and after incorporation. Depreciation shall be provided at 25% p.a. on fixed Assets.

[C.A. (Inter) — Adapted] [C.U.B.com. (Hons.) — Adapted]

Solution

Exe Pvt. Ltd.
Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit (A)	(1)	90,000	24,000	66,000
Less : Expenses (B) :				
Carriage Outwards	(2)	3,300	880	2,420
Traveller's Communication	(2)	7,500	2,000	5,500
Office Salaries	(2)	21,000	5,250	15,750
Administrative Expenses	(3)	19,900	4,975	14,925
Rent and Rates	(3)	12,000	3,000	9,000
Director's Fees	(4)	18,000	—	18,000
Preliminary Expenses	(5)	5,200	—	5,200
Depreciation	(6)	25,000	6,250	18,750
		1,11,900	22,355	89,545
Net Profit (A – B)		(21,900)	1,645 Capital Profit	(23,545) Revenue Loss
Transferred to			Capital Reserve	Statement of Profit and Loss

Working Notes:

In this problem the gross profit has not been given. so, first of all, a statement is to be prepared for calculating gross profit.

(1) Calculation of Gross Profit

		₹
Sales		2,78,000
Less: Cost of goods sold		
Opening Stock	43,000	
Add: Purchases	1,89,000	
	2,32,000	
Less: Closing Stock	44,000	1,88,000
Gross Profit		90,000

Gross profit is apportioned in the ratio of sales which is calculated as follows:

Let the average monthly sales of April 2016, February 2017 and March 2017, be ₹ 100, then average monthly sales of remaining 9 months are ₹ 50. Therefore, the sales of pre-incorporation and post-incorporation period will be:

Pre-incorporation period	₹	Post-incorporation period	₹
April, 2016	100	July 2016 to Jan 2017 @ ₹ 50	350
May, 2016	50	February, 2017	100
June, 2016	50	March, 2017	100
	200		550

Therefore, sales ratio = 20:55 or 4:11. Gross profit of pre-incorporation period

$= \frac{90,000}{15} \times 4 =$ ₹ 24,000 and that of Post-incorporation period $= \frac{90,000}{15} \times 11 =$ ₹ 66,000

(2) Carriage outwards: Pre — $\frac{3,300}{15} \times 4 =$ ₹ 880 ; Post — $\frac{3,300}{15} \times 11 =$ ₹ 2,420

Travellers' commission : Pre — $\frac{7,500}{15} \times 4 =$ ₹ 2,000 ; Post — $\frac{7,500}{15} \times 11 =$ ₹ 5,500

(3) These expenses accrue evenly throughout the year and are therefore divided on the time basis, i.e. 3:9.

(4) Directors' fees are paid in case of company only. These must naturally be shown in post-incorporation period.

(5) Strickly to Appropriation Account, it can be written-off against pre-incorporation profit.

(6) Depreciation is apportioned on the basis of time, i.e. 3:9 or 1:3.

Illustration 7

Kalyan Kumar formed a private limited company under the name of Kalyan Pvt. Ltd. to take over his existing business as from April 1, 2016, but the company could not be incorporated till July 1, 2016. No entries relating to transfer of the business were entered in the books, which were carried on without a break till March 31, 2017. The following Trial Balance was extracted from the books as on March 31, 2017:

Heads of Account	Dr.	Cr.
Inventory, April 1, 2016	4,300	
Sales		27,800
Purchases	18,900	
Carriage outwards	330	
Travellers' commission	750	
Office salaries and expenses	2,100	
Rent and rates	1,200	
Kalyan Kumar's Capital A/c, April 1, 2016		23,000
Directors' Fees	1,800	
Fixed assets — Tangible	13,400	
Current liabilities		3,700
Current assets (other than stock)	11,200	
Preliminary expenses	520	
TOTAL	54,500	54,500

You are also given the following information:

(a) Inventory on March 31, 2017, ₹ 4,400.

(b) The purchase consideration was agreed at ₹ 30,000 to be satisfied by the the issue of 3,000 equity shares of ₹ 10 each.

(c) The gross profit margin is constant and the monthly sales in April, 2016, February, 2017 and March, 2017 are double the monthly sales for the remaining months of the year.

(d) The preliminary expenses are to be written-off.

(e) You are to assume that carriage outwards and travellers' commission vary in direct proportion to sales.

You are required to calculate Gross Profit and prepare a Statement of Profit and Loss for the year ended March 31, 2017 apportioning the periods before and after incorporation, and a Balance Sheet as on that date. Ignore depreciation.

Solution

Kalyan Pvt. Ltd.
Calculation of Gross Profit

Particulars		₹
Sales		27,800
Add : Closing Stock		4,400
		32,200
Less : Purchases	18,900	
Less: Opening Inventories	4,300	23,200
Gross Profit		9,000

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit (A)	(3)	9,000	2,400	6,600
Less : Expenses (B) :				
Carriage Outward	(4)	330	88	242
Travellers' Commission	(4)	750	200	550
Office Salaries	(5)	2,100	525	1,575
Rent and Rates	(5)	1,200	300	900
Directors' Fees	(6)	1,800	—	1,800
Preliminary Expenses	(7)	520	—	520
		6,700	1,113	5,587
Net Profit (A – B)		2,300	1,287 Capital Profit	1,013 Revenue Profit
Transferred to			Capital Reserve	Statement of Profit and Loss

Balance Sheet of Kalyan Pvt. Ltd. as at 31st March, 2017

Particulars	Note No.	(₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	30,000
(b) Reserves and Surplus	(2)	2,300
(2) Share Application Money Pending Allotment :		
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables		—
(c) Other Current Liabilities		3,700
(d) Short-term Provisions		—
TOTAL		36,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(8)	13,400
(ii) Intangible Assets — Goodwill	(9)	7,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		4,400
(c) Trade Receivables		—
(d) Cash and Cash Equivalents		—
(e) Short-term Loans and Advances		—
(f) Other Current Assets		11,200
TOTAL		36,000

Notes to Accounts :

Particulars	(₹)
(1) Share Capital	
Issued, Subscribed and Paid-up Capital :	
3,000 Equity Shares of ₹ 10 each (Issued for consideration other than cash)	30,000
(2) Reserve and Surplus	
(i) Capital Reserve — Pre-incorporation Profit	1,287
(ii) Profit and Loss	1,013
	2,300

Working Notes:

(3) to **(7)** are similar to previous ***Illustration***.

(8) These figures are subject to depreciation.

(9) Goodwill represents the difference between the amount of purchase consideration and balance of capital of Kalyan. ₹ 30,000 – ₹ 23,000 = ₹ 7,000.

Illustration 8

The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 2016. The consideration was agreed at ₹ 1,17,00,000 based on the firm's Balance Sheet as at 31st December, 2014.

However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2016. Meanwhile, the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% p.a. The same books of accounts were continued by the company which closed its account for the first time on 31st March, 2017.

Prepare the following summarised Profit and Loss Account (all figures in ₹):

Sales	2,34,00,000
Cost of goods sold	1,63,80,000
Salaries	11,70,000
Depreciation	1,80,000
Advertisements	7,02,000
Discounts	11,70,000
Managing director's remuneration	90,000
Miscellaneous office expenses	1,20,000
Office-cum-showroom rent	7,20,000
Interest	9,51,000
	2,14,83,000
Profit	19,17,000

The company's only borrowing was a loan of ₹ 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm, from 1st April 2016 but the salaries trebled from that date. It had to occupy additional space from 1st July, 2016, rent for which was ₹ 30,000 p.m.

Prepare a Statement of Profit and Loss in columnar form apportioning costs and revenue between pre-incorporation and post- incorporation periods. Also, suggest, how the pre-incorporation profits are to be dealt with.

MA (P) Ltd.
Statement of Profit and Loss for 15 months ended on 31st March, 2017

Particulars	Note No.	Total ₹	Pre-incorporation* ₹ ('000)	Post-incorporation** ₹ ('000)
Gross Profit (A)	(1)	7,020	780	6,240
Less : Expenses (B) :				
Salaries	(2)	1,170	90	1,080
Depreciation	(3)	180	36	144
Advertisement	(4)	702	78	624
Discounts	(4)	1,170	130	1,040
MD's Remuneration	(5)	90	—	90
Miscellaneous Office Expenses	(3)	120	24	96
Rent	(6)	720	90	630
Intereset	(7)	951	351	600
		5,103	799	4,304
Net Profit (A – B)		1,917	(19) Capital Loss	1,936 Revenue Profit
Transferred to			Goodwill	Statement of Profit and Loss

* Pre-incorporation period = 3 months (1.1.2016 to 31.3.2016)

** Post-incorporation period = 12 months (1.4.2016 to 31.3.2017)

Pre-incorporation profit may be dealt with as follows :

(i) Credited to Capital Reserve;

(ii) Credited to Goodwill Account to reduce the amount of goodwill;

(iii) Utilise to reduce the value of fixed assets acquired.

Working Notes:

(1) Gross profit = Sales – Cost of goods sold = ₹ 2,34,00,000 – 1,63,80,000 = ₹70,20,000.

Gross Profit is apportioned in the ratio of sales which is calculated as follows:

Let , the average monthly sales of 3 months ending on 31st March, 2016 = ₹100.The average monthly sales of remaining 12 months starting from 1st April 2016 = ₹ 100 x 2 =200. The total sales of pre-incorporation period will be = 100 x 3 = ₹ 300 and that of post-incorporation period will be ₹ 200 x 12 = 2400. Therefore, the ratio of sales will be: 3:24 or 1:8.

Gross profit of Pre — $\frac{70,20,000}{9} \times 1$ = ₹ 7,80,000

Post — $\frac{70,20,000}{9} \times 8$ = ₹ 62,40,000

(2) Let, the pre-incorporation monthly salary =₹ 100 . Therefore, the monthly salary of post-incorporation period = ₹ 100 x 3 = 300. Total salary of pre-incorporation period =₹ 100 x 3 =300 and that of post-incorporation period =₹ 300 x 12 = 3,600. Hence, the ratio = 300 : 3,600 or1:12

(3) These expenses have been apportioned on the basis of time:3:12 or1:4.

(4) Advertisement and discounts are apportioned in the ratio of sales i.e., 1:8.

(5) **Managing Directors' remuneration is related to post-incorporation period.**

(6) Rent to be apportioned as follows:

Total rent as per Profit and Loss Account	= ₹ 7,20,000
Less : Additional rent for 9 months @ ₹ 30,000	= ₹ 2,70,000
Rent of old premises for 15 months	₹ 4,50,000

Therefore, rent of pre-incorporation period is calculated as $= \frac{4,50,000}{15} \times 3 =$ ₹ 90,000

and that of post-incorporation period $= \frac{4,50,000}{15} \times 12 +$ ₹ 2,70,000 = ₹ 6,30,000.

(7) Interest for the pre-incorporation period is calculated as

$$\frac{12}{100} \times \text{Rs } 1,17,00,000 \times \frac{3}{12} = \text{Rs } 3,51,000.$$

The balance interest (₹ 9,51,000 – ₹ 3,51 000) = ₹ 6,00,000 is related to post-acquisition period.

(8) Treatment of Pre-incorporation Loss:
Pre-incorporation loss can be treated in the books of accounts in any of the following manners:
(a) It can be debited to Goodwill Account;
(b) It can be debited to Capital Reserve Account arising from acquisition transaction.

Illustration 9

Chaitanya Industries Private Ltd was incorporated on 1.2.2016. It took over the proprietary business of Chaitanya, with effect from 1.1.2016. The Balance Sheet of Chaitanya as at 31st December 2014 is as follows:

Liabilities	₹	Assets	₹
Capital	4,31,500	Sundry debtors	25,700
Trade creditors	17,000	Building	1,10,000
Loans	8,500	Machinery	3,00,000
Creditors expenses	2,500	Loss	23,800
	4,59,500		4,59,500

It was agreed to pay ₹ 4,50,000 in equity shares to Chaitanya. The company decided to close its first year's accounts as at 31st December 2016. The following are the further details furnished to you:

Sales ₹ 3,00,000; Purchases ₹ 1,40,000; Salaries and wages ₹ 40,000; General expenses ₹ 32,000; Freight ₹ 4,700; Interest paid ₹ 8,000; Inventories ₹ 22,000; Additions to building ₹ 38,000; Depreciation may be provided at 10% on assets including additions.

The company has requested you to prepare:

(1) the journal entries for the take-over;
(2) Chaitanya's Account; and
(3) A Statement of Profit and Loss showing separately pre-incorporation and post-incorporation profits for the year ending 31st December 2016.

Solution **In the Books of Chaitanya Industries (Pvt.) Ltd.**

Journal **Dr.** **Cr.**

Date	Particulars		₹	₹
2016	Goodwill A/c (Balancing figure)	Dr.	42,300	
Jan. 1	Building A/c	Dr.	1,10,000	
	Machinery A/c	Dr.	3,00,000	
	Sundry Debtors A/c	Dr.	25,700	
	To Loan A/c			8,500
	To Trade Creditors A/c			17,000
	To Creditors for Expenses A/c			2,500
	To M/s Chaitanya (Vendors) A/c			4,50,000
	(Being sundry assets and liabilities of M/s Chaitanya taken over as per agreement dated ...)			

M/s Chaitanya (Vendors) A/c	Dr.	4,50,000	
To Equity Shares Capital A/c			4,50,000
(Being the issue of shares for satisfying purchase consideration)			

Dr. M/s Chaitanya Account Cr.

Particulars	₹	Particulars	₹
To Share capital	4,50,000	By Sundries (net assets taken over)	4,50,000
	4,50,000		4,50,000

Working Notes:

(1) Calculation of Gross Profit

Sales		3,00,000
Purchases	1,40,000	
Freight	4,700	
	1,44,700	
Less: Closing Inventories	22,000	1,22,700
		1,77,300

For lack of information, Gross Profit and all expenses have been apportoned on the basis of time, i.e., 1 : 11.

(2) Depreciation on Building : 10% (₹ 1,10,000 + ₹ 38,000) = ₹ 14,800.

Chaitanya Industries (Pvt.) Ltd.
Statement of Profit and Loss for the year ended 31st December, 2016

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit (A)	(1)	1,77,300	14,775	1,62,525
Less : Expenses (B) :				
Salaries and Wages		40,000	3,333	36,667
General Expenses		32,000	2,667	29,333
Interest Paid		8,000	667	7,333
Depreciation on :				
Building	(2)	14,800	1,233	13,567
Machinery		30,000	2,500	27,500
		1,24,800	10,400	1,14,400
Net Profit (A – B)		52,500	4,375 Capital Profit	48,125 Revenue Profit
Transferred to			Capital Reserve	Statement of Profit and Loss

Illustration 10

The Sai Deep Ltd. was incorporated on 1st August, 2016, to take over the running business of Krishna Bors with effect from 1st April, 2016. The company received the certificate of commencement of business on 1st October, 2016. The following Profit and Loss Account was prepared for the year ended 31st March, 2017 :

Dr. Profit and Loss Account for the year ended 31st March, 2017 Cr.

Particulars	₹	Particulars	₹
To Office Salaries	21,000	By Gross Profit b/d	80,000
To Partners' Salaries	6,000	By Share Transfer Fees	1,000
To Advertisement	4,400		
To Printing & Stationery	1,500		
To Travelling Expenses	4,000		
To Office Rent	9,600		
To Electricity Charges	900		
To Auditors Charges	600		
To Directors Charges	1,000		
To Bad Debts	1,200		
To Commission on Sales	4,000		
To Preliminary Expenses	700		
To Debenture Interest	1,800		

To Interest on Capital	1,600		
To Depreciation	2,100		
To Net Profit	20,600		
	81,000		81,000

Additional information :

(1) Total Sales for the year, which amounted to ₹ 8,00,000 arose evenly up to the date of certificate of commencement, whereafter they recorded an increase of 2/3 during the remaining period. Gross profit was an uniform rate of 10% of selling price throughout the year and a commission of 0.5% was paid on sales.

(2) Office rent was paid @ ₹ 8,400 p.a. up to 30th September, 2016 and thereafter it was paid @ ₹ 10,800 p.a.

(3) Travelling expenses include ₹ 1,600 towards sales promotion.

(4) Bad Debts written off—

(a) A debt of ₹ 400 taken over from the vendor;

(b) A debt of ₹ 800 in respect of goods sold in September 2016.

Depreciation includes ₹ 600 for assets acquired in the post-incorporation period.

Show the "pre" and "post" incorporation results and also state how the results of pre- and post-incorporation is dealt with.

Solution

Sai Deep Ltd.

Statement of Profit and Loss for the year ended 31st March, 2017

Particulars	Note No.	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit	(1)	80,000	20,000	60,000
Share Transfer Fees	(17)	1,000	—	1,000
Total (A)		81,000	20,000	61,000
Less : Expenses (B) :				
Office Salaries	(2)	21,000	7,000	14,000
Partners' Salaries	(3)	6,000	6,000	—
Advertisement	(4)	4,400	1,100	3,300
Printing and Stationery	(5)	1,500	500	1,000
Travelling Expenses	(6)	2,400	800	1,600
Sales Promotion	(6a)	1,600	400	1,200
Office Rent	(7)	9,600	2,800	6,800
Electricity Charges	(8)	900	300	600
Auditor's Charges	(9)	600	200	400
Directors' Charges	(10)	1,000	—	1,000
Bad Debts	(11)	1,200	400	800
Commission on Sales	(12)	4,000	1,000	3,000
Preliminary Expenses	(13)	700	—	700
Debenture Interest	(14)	1,800	—	1,800
Interest on Capital	(15)	1,600	1,600	—
Depreciation	(16)	2,100	700	1,400
		60,400	22,800	37,600
Net Profit (A – B)		20,600	(2,800) Capital Loss	23,400 Revenue Profit
Transferred to			Goodwill Account	Statement of Profit and Loss

Working Notes :

(1) Let the average monthly sales = x. The sales of different months can be shown as follows:

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	1x	1x	1x	1x	1x	1x	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$	$1\frac{2}{3}x$

Date of incorporation Certificate of commencement

Ratio of sales = 4x : 12x or 1 : 3.

Gross Profit is apportioned in the ratio of sales:

Pre — $\frac{80,000}{4} \times 1 =$ ₹ 20,000 ; Post — $\frac{80,000}{4} \times 3 =$ ₹ 60,000

The date of incorporation is 1st August, 2016. The date of obtaining Certificate of Commencement is 1st October, 2016. It is common practice that the date of incorporation should be taken as the basis of calculation of pre-acquisition profit.

(2) Pre-incorporation period consist of 4 months and post-incorporation period consist of 8 months. Therefore, the ratio of time = 4 : 8 or 1 : 2. Office salaries are apportioned in the ratio of time.

Pre — $\frac{21,000}{3} \times 1 =$ ₹ 7,000 ; Post — $\frac{21,000}{3} \times 2 =$ ₹ 14,000

(3) Partners' salary is exclusively related to pre-acquisition period.

(4) Advertisement is apportioned in the ratio of sales.

Pre — $\frac{4,400}{4} \times 1 =$ ₹ 1,100 ; Post — $\frac{4,400}{4} \times 3 =$ ₹ 3,300

(5) Printing and staionery is apportioned in the ratio of time , i.e., 1 : 2.

Pre — $\frac{1,500}{3} \times 1 =$ ₹ 500 ; Post — $\frac{1,500}{3} \times 2 =$ ₹ 1,000

(6) Travelling expenses are apportioned in the ratio of time, i.e., 1 : 2.

Pre — $\frac{2,400}{3} \times 1 =$ ₹ 800 ; Post — $\frac{2,400}{3} \times 2 =$ ₹ 1,600

(6a) Promotion expenses are apportioned in the ratio of sales, i.e., 1 : 3.

Pre — $\frac{1,600}{4} \times 1 =$ ₹ 400 ; Post — $\frac{1,600}{4} \times 3 =$ ₹ 1,200

(7) Office rent is to be apportioned on actual basis.

Pre — $\frac{8,400}{12} \times 4 =$ ₹ 2,800 ; Post — $\frac{8,400}{12} \times 2 + \frac{10,800}{12} \times 6 =$ ₹ 5,400 + ₹ 1,400 = ₹ 6,800

(8) Electricity charges are apportioned in the ratio of time, i.e., 1 : 2.

Pre — $\frac{900}{3} \times 1 =$ ₹ 300 ; Post — $\frac{900}{3} \times 2 =$ ₹ 600

(9) Auditor's charges are apportioned in the ratio of time, i.e., 1 : 2.

Pre — $\frac{600}{3} \times 1 =$ ₹ 200 ; Post — $\frac{600}{3} \times 2 =$ ₹ 400

(10) Directors' charges are paid in case of company only. These must naturally be shown in the post-incorporation period.

(11) Bad debts are to be apportioned on actual basis : Pre — ₹ 400; Post — ₹ 800.

(12) Commission on sales is apportioned in the ratio of sales, i.e., 1 : 3.

Pre — $\frac{4,000}{4} \times 1 =$ ₹ 1,000 ; Post — $\frac{4,000}{4} \times 3 =$ ₹ 3,000

(13) Preliminary expenses are related to post-incorporation period.

(14) Debentures interest is related to post-incorporation period.

(15) Interest on capital is related to pre-acquisition period.

(16) Depreciation is apportioned in the ratio of time, i.e., 1 : 2.

Pre — $\frac{2,100}{3} \times 1 =$ ₹ 700 ; Post — $\frac{2,100}{3} \times 2 =$ ₹ 1,400

(17) Share transfer fees are related to post-incorporation period.

KEY POINTS

- Any profit prior to incorporation may be dealt with as follows:
  (a) Credited to Capital Reserve Account
  (b) Credited to Goodwill Account to reduce the amount of goodwill arising from acquisition of business.
  (c) Utilised to write down the value of fixed assets acquired.
- Any loss prior to incorporation may be dealt with as follows:
  (a) Debited to Goodwill Account
  (b) Debited to Capital Reserve Account arising from acquisition of business.
  (c) Debited to a Suspense Account, which can be written-off later as a fictitious asset.
- Profit earned before incorporation is a ***capital profit*** and profit earned after incorporation is a ***revenue profit***.
- It is a common practice that the date of incorporation should be taken as the basis for calculation of pre-acquisition profit since obtaining a certificate of commencement of business is purely a legal formality.

THEORETICAL QUESTIONS

1. Explain the different methods of computing profit prior to incorporation.
2. State the accounting treatment of pre-incorporation profit / loss.
3. State the accounting treatment of post-incorporation profit / loss.
4. Write short notes on:
   (a) Profit prior to incorporation; (b) Loss prior to incorporation;
   (c) Certificate of incorporation; (d) Certificate of commencement of business.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Profit prior to incorporation is
   A debited to Goodwill Account
   B credited to General Reserve Account
   C credited to Capital Reserve Account
2. Profit earned before incorporation is a/an
   A extra ordinary profit
   B revenue profit
   C capital profit
3. Profit earned after incorporation but before obtaining certificate of commencement of business is generally treated as :
   A revenue profit
   B capital profit
   C extraordinary profit
4. Loss prior to incorporation is
   A credited to Capital Reserve Account
   B debited to Goodwill Account
   C credited to Goodwill Account
5. After-sales service cost is allocated
   A on the basis of time
   B on the basis of sales
   C on actual basis

PRACTICAL QUESTIONS

1. Shiva and Bishnu working in partnership registered a Joint Stock Company under the name of "Om Bishnu Ltd" on 1st September, 2016 to take over their existing business with effect from 1st April, 2016. (all figures in rupees)

Dr. Profit & Loss Account for the year ended 31.03.2017 Cr.

To Salaries & wages	10,000	By Gross Profit b/d	84,000
To Debentures interest	5,000		
To Depreciation	2,000		
To Interest on purchase consideration (upto 30.9.2016)	10,800		
To Selling commission	12,000		
To Director's fees	800		
To Preliminery expenses written-off	1,000		
To Provision for taxes	5,000		
To Dividend on equity shares @ 5%	6,000		
To Balance carried down	31,400		
	84,000		84,000

Sales for the year totalled ₹ 2,25,000, out of which ₹ 1,50,000 related to the period from 1st September, 2016, to 31st March, 2017.

Prepare a statement apportioning the profits between post- and pre- incorporation period indicating your basis of allocation. ***[I.C.W.A. (Inter) — Adapted]***

2. Pawan Ltd was incorporated on 1st March, 2017 and received its certificate of commencement of business on 1st April, 2017. The company bought the business of Pramod Ltd with effect from 1st November, 2016. From the following figures relating to the year ending October, 2017, find out the profit available for dividends :
   (i) Sales for the year were ₹ 3,00,000 out of which sales upto 1st March were ₹ 1,25,000.
   (ii) Gross profit for the year was ₹ 90,000.
   (iii) Expenses debited to the Profit and Loss Account were :

	₹
Rent	4,500
Salaries	7,500
Directors' fees	2,400
Interest on debentures	2,500
Audit fees	750
Discount on sales	1,800
Depreciation	12,000
General expenses	2,400
Advertising	9,000
Stationery and printing	1,800
Commission on sales	3,000
Bad debts	*750
Interest to vendor on purchase consideration upto 1.5.2017	1,500

*₹ 250 relate to debts created prior to incorporation.

[C.S. (Inter) — Adapted]

3. A company was incorporated on 1st May, 2016 to take over a business from the preceding 1st January. The accounts were made upto 31st December, 2016 as usual and the Trading and Profit and Loss Account gave the following result:

Particulars	₹	Particulars	₹
To Opening Stock	1,40,000	By Sales	12,00,000
To Purchases	9,10,000	By Closing Stock	1,50,000
To Gross Profit c/d	3,00,000		
	13,50,000		13,50,000
To Rent, Rates and Insurance	18,000	By Gross Profit b/d	3,00,000
To Director's Fees	20,000		
To Salaries	51,000		
To Office Expenses	48,000		
To Travellers' Commission	12,000		
To Discounts	15,000		
To Bad Debts	3,000		
To Audit Fees	8,500		

To Depreciation	6,000		
To Debenture Interest	4,500		
To Net Profit	1,14,000		
	3,00,000		3,00,000

It is ascertained that the sales for November and December are one and half times the average of those for the year, whilst those for February and April are only half the average.
Apportion the year's profit between the pre-incorporation and the post-incorporation period.

[C.S. (Inter) — Adapted]

4. Sarvottam Ltd was incorporated on January 1, 2016 with an authorised capital of ₹ 50,000 to take over the running business of Uttam Bros. from October 1, 2014. The following is the summarised Profit and Loss Account for the year ending September 30,2016.

	₹	₹
Sales from 1.10.2014 to 31.12.2014	60,000	
Sales from 1.1.2016 to 30.9.2016	1,90,000	2,50,000
Cost of Sales for the year	1,54,000	
Administrative expenses	17,680	
Selling commission	8,750	
Goodwill written-off	2,000	
Interest to Vendors (loan repaid on 1.2.2016)	3,730	
Distribution expenses (60% variables)	12,500	
Preliminary expenses	3,300	
Debenture interest	3,200	
Depreciation	4,440	
Directors' fees	1,000	2,16,600
Net profit		33,400

The company deals in only one product. The cost of sales per unit was reduced by 10% in the post-incorporation period, as compared to the pre-incorporation period.
Prepare a statement showing the net profit of the pre-and post-incorporation period. Also show the basis of apportionment. ***[C.S. (Inter) — Adapted]***

5. Adarsh Udyog Ltd incorporated on 1st May, 2016, received the certificate to commence business on 31st May, 2016. It had acquired a running business from Gupta and Co with effect from 1st January, 2016. The purchase consideration was ₹ 50,00,000 of which ₹ 10,00,000 was to be paid in cash and ₹ 40,00,000 in the form of fully paid shares. The company also issued shares for ₹ 40,00,000 for cash. Machinery costing ₹ 25,00,000 was then installed. Assets acquired from the vendors were : machinery — ₹ 30,00,000; stock — ₹ 6,00,000; and patents — ₹ 4,00,000.
During the year 2016 the total sales were ₹ 1,80,00,000, the sales per month in the first half-year being one-half of what they were in the latter half-year.
The net profit of the company, after charging the following expenses, was ₹ 10,00,000 :
Depreciation—₹ 5,40,000; Audit fees — ₹ 26,000; Director's fees — ₹ 60,000; Preliminary expenses—₹ 10,000; Office expenses — ₹ 2,40,000; Selling expenses — ₹ 1,98,000; Interest to vendors — ₹ 50,000
Ascertain the pre-incorporation and post-incorporation amounts of profit and prepare the Balance Sheet of the company as on 31st December, 2016. The closing stock was valued at ₹ 7,00,000. ***[C.S. (Inter) — Adapted]***

6. X and Y who were working as partners formed a limited company in the name of XY(P) Ltd, on 1st June, 2016 to take over their existing business, with the consideration being a sum of ₹ 4,80,000 and the condition that until the amount was discharged, they would pay interest @6% p.a. from 1st January, 2016. The amount was paid on June 30, 2016. To discharge the purchase consideration, the company issued 30,000 Equity Shares of ₹ 10 each at a premium of ₹ 1 each for cash and allotted 7% Debentures of the face value of ₹ 2,00,000 to the vendors at par. The following was the Profit and Loss Account of XY (P) Ltd for the year ended 31.12.2016.

Dr.			Cr.
To Purchases including stock	2,00,000	By Sales	2,70,000
To Freight and cartage	10,000	By Closing stock	21,000
To Gross profit c/d	81,000		
	2,91,000		2,91,000
To Salaries and wages	15,000	By Gross Profit b/d	81,000
To Debenture interest	7,000		
To Depreciation	1,500		

To Interest on purchase consideration	14,400		
To Selling commission	13,500		
To Directors' fees	1,200		
To Preliminary expenses written-off	1,800		
To Provision for taxation	8,000		
To Dividend on equity shares	7,500		
To Balance c/d	11,100		
	81,000		81,000

You are required to prepare a statement apportioning the balance between the post- and pre-incorporation periods assuming that the sales in the post-incorporation period were double the same in the pre-incorporation period. Show how these figures would appear in the Balance Sheet of XY (P) Ltd. ***[C.S. (Inter) — Adapted]***

7. A decides to convert his business into a limited company with effect from 1st January, 2016 and issues for cash 10,000 equity shares of ₹ 10 each at par to his friends and customers. From the proceeds vendor was paid ₹ 80,000 plus the amount of reimbursement of his outlay in the formation of the company amounting to ₹ 4,200, the balance due being settled by the allotment of the remaining 2,000 shares at par on new book opened.

Trial Balance as at 31st December, 2016

	Dr. (₹)	Cr. (₹)		Dr. (₹)	Cr. (₹)
Capital (₹ 64,000 on 1.1.2016)	20,000		Bad debts	1,450	
Formation expenses	4,200		Debtors and creditors	33,500	21,500
Shares issued		80,000	Furniture and fixtures	7,000	
Purchases and sales	1,80,000	2,24,500	Land	45,000	
Stock on 1.1.2016	13,000		Cash and Bank balance	5,850	
General expenses	16,000		TOTAL	3,26,000	3,26,000

Stock on 31st December, 2016, ₹ 25,500.

The furniture and fixtures are revalued at ₹ 10,500 and debtors at ₹ 12,000, out of which ₹ 1,100 proved to be bad.

A is to get a salary of ₹ 12,000 p.a. commencing from the date of incorporation, i.e., March 1st, 2016 and interest @ 6% p.a. to that date on the principal amount due to him.

Profit prior to incorporation to be calculated on time basis excluding A's salry and interest to be charged against such profit.

Prepare the Trading and Profit and Loss Account for the year ended 31st December, 2016 and the balance sheet as at that date, giving effect to all necessary adjustments, none of which has been entered in the books, except that A's Capital has been debited with each proceeds of the share-issue paid to him, formation expenses and ₹ 4,000 on account of salary. No further amounts of salary and interest due to him have been paid. Ignore income-tax.

[C.S. (Inter) — Adapted]

8. Rowlock Ltd. was incorporated on 1st October, 2016 to acquire Rowlock's mail order business, with effect from 1st June, 2016.

The purchase consideration was agreed at ₹ 35,000 to be satisfied by the issue on 1st December, 2016 to Rowlock or his nominee of : 20,000 equity shares of Re 1 each, fully paid and ₹ 15,000, 7% Debentures. The entries relating to the transfer were not made in the books which were carried on without a break until 31st May, 2017.

On 1st May, 2017 the Trial Balance extracted from the books showed the following :

Particulars	₹	Particulars	₹
Sales	52,185	Director's salary	1,000
Purchases	38,829	Debenture Interest (gross)	525
Wrapping	840	Fixed Assets	25,000
Postage	441	Current Assets (other than Stock)	9,745
Warehouse rent and rates	921	Current Liabilities	4,162
Packing expenses	1,890	Formation expenses	218
Office expenses	627	Capital Account — Rowlock, 31st May, 2016	29,450
Stock on 31st May, 2016	5,261	Drawings Account — Rowlock	500

You also ascertain the following:

(1) Stock, 31st May 2017 amounted to ₹ 4,946.

(2) The average monthly sales for June, July and August were one-half of those for the remaining months of the year. The gross profit margin were constant throughout the year.

(3) Wrapping, postage and packing expenses varied in direct proportion to sales, while office expenses were constant each month.

(4) Formation expenses are to be written off.

You are required to prepare the Trading and Profit and Loss Account for the year ended 31st May, 2017 apportioned between the periods before and after incorporation and Balance Sheet as on the date. ***[C.S. (Inter) — Adapted]***

9. New Ventures Ltd. was incorporated on 1st July, 2016 with an authorised capital consisting of 5,000 equity shares of ₹ 10 each to take over the running business of Rundown Brothers as from 1st April, 2016. The following is the summarised Profit and Loss Account for the year ended 31st March, 2017:

Dr. Profit and Loss Account for the year ended 31st March, 2017 Cr.

Particulars	₹	Particulars		₹
Cost of Sales for the year	16,000	Sales		
Administrative Expenses	1,768	1st April, 2016 to 30th June, 2016	6,000	
Selling Commission	875	1st July, 2016 to 31st March, 2017	19,000	25,000
Goodwill written off	200			
Interest paid to Vendors (Loan repaid on 1st August)	373			
Distribution Expenses (60 per cent variable)	1,250			
Preliminary Expenses written off	330			
Debenture Interest	320			
Depreciation	444			
Directors Fees	100			
Net Profit	3,340			
	25,000			25,000

The company deals in one type of product. The unit cost of sales was reduced by 10 per cent in the post-incorporation period as compared to the pre-incorporation period in the year. You are required to apportion the net profit amount between pre-incorporation and post-incorporation periods showing the basis of apportionment.

10. A company was incorporated on 1st July, 2016 to take over the business of Mr M as and from 1st April, 2016. Mr M's Balance Sheet as at that date was as under :

Liabilities	₹	Assets	₹
Trade Creditors	36,000	Building	80,000
Capital	1,94,000	Furniture and Fittings	10,000
		Debtors	90,000
		Stock	30,000
		Bank	20,000
	2,30,000		2,30,000

Debtors and Bank balances are to be retained by the vendor and creditors are to be paid off by him. Realisation of debtors will be made by the company on a commission of 5% on cash collected. The company is to issue M with 10,000 equity shares of ₹ 10 each, ₹ 8 per share paid and cash of ₹ 56,000.

The company issued to the public for cash 20,000 equity shares of ₹ 10 each on which by 31st March, 2017, ₹ 8 per share was called and paid up except in the case of 1,000 shares on which the third call of ₹ 2 per share had not been realised. In the case of 2,000 shares, the entire face value of the shares had been realised. The share issue was underwritten for 2 % commission, payable in shares fully paid up.

In addition to the balances arising out of the above, the following were shown by the books of account of the company on 31st March, 2017 :

	₹
Discount (including ₹ 1,000 allowed on vendor's debtors)	6,000
Preliminary expenses	10,000
Director's fees	12,000
Salaries	48,000
Debtors (including vendor's debtors)	1,60,000
Creditors	48,000
Purchases	3,20,000
Sales	4,60,000

Stock on 31st March, 2017 was ₹ 52,000. Depreciation at 10% on Furniture and fittings and at 5% on Building is to be provided. Collections from debtors belonging to the vendor were ₹ 60,000 in the period.

Prepare the Trading and Profit and Loss Account for the period ended 31st March, 2017 of the limited company and its Balance Sheet as at that date.

11. S. Nigam decided to covert his business into a limited company as and from 1st April, 2016, and decided to become a director on a monthly salary of ₹ 1,000. The company was duly incorporated on 1st May, 2016 under the name of M/s Nigam Limited and received a commencement certificate on 1st June, 2016. On 1st May, 2016, 18,000 equity shares of ₹ 10 each were issued for cash and S Nigam retained 2,000 equity shares as part consideration.
Out of proceeds of the issue, S Nigam was paid ₹ 1,40,000 as the balance of the purchase price and ₹ 15,000 for expenses incurred by him in connection with the formation of the company. S Nigam continued same set of books and accounts. The Trial Balance, before adjustment, at 31st March, 2017 is as follows :

Particulars	Dr. (₹)	Cr. (₹)
Capital Account (S Nigam)	25,000	
New Company Account (Nigam Limited)		1,80,000
Sales		6,00,000
Stock (1.4.2016)	18,000	
Purchases	4,40,000	
Salaries	55,000	
Administrative Expenses	44,000	
Selling Expenses	6,000	
Bad Debts Written-off	3,500	
Creditors		66,500
Debtors	1,00,000	
Building	1,20,000	
Cash at Bank	35,000	
	8,46,500	8,46,500

Shri Nigam has not been credited with salary to date nor has he received anything on account. the stock at 31st March, 2017 is valued at ₹ 8,000.
A revaluation on 1st April, 2016 showed that the building was worth ₹ 1,30,000 and that ₹ 5,000 of debts were doubtful or bad. Against the latter it was agreed to provide ₹ 4,000. Actually only debts to the value of ₹ 2,000 have proved to be bad, the balance having been collected by the company.
Capital of Shri Nigam on 1st April, 2016 was ₹ 1,30,000.
Prepare Balance Sheet of M/s Nigam Limited as at 31st March, 2017 with relative Profit and Loss Account to the date, giving effect to the adjustments necessary, but yet unrecorded, on account of the change of ownership.

[C.A. (Inter) — Adapted]

12. Tara Industries Ltd. agreed to take-over the business of Sri K. Basak from 31st March, 2016 in consideration of ₹ 66,000 to be discharged by the issue of equity shares only. On that day, the Balance Sheet of Sri K. Basak was:

Liabilities	₹	Assets	₹
Sundry creditors	30,000	Cash balances	2,000
Loans : S. Sarkar	6,000	Sundry debtors	22,000
Capital	60,000	Furniture	15,000
		Machinery	45,000
		Goodwill	10,000
		Profit & Loss Account	2,000
	96,000		96,000

The company was registered on 1st May, 2016 as a public limited company and obtained a commencement certificate to business on 1st July, 2016. The authorised capital was ₹ 5,00,000 divided into 50,000 equity shares of ₹ 10 each. The company issued for cash 15,000 equity shares to the public at a premium of ₹ 2 per share. The same set of books were continued by the Company and no entries were passed in the books for the take-over of business. Loan from S. Sarkar was repaid before 31st March, 2017.
Apart from this information, the following balances as on 31st March, 2017 were also given:

Particulars	₹	Particulars	₹
Sundry creditors	34,500	Bank overdraft	21,000
Cash balance	8,000	Purchases	1,81,000
Salary and wages	68,000	Freight	6,000
Sales	3,00,000	Other expenses	10,000
New Machinery	95,000	Interest paid	3,000

You are required to prepare the final accounts of Tara Industries Ltd for 2016-17 after taking into account stock of ₹ 15,000 on 31st March, 2017 and after providing for depreciation on assets at 10%.

13. ABC Ltd. was incorporated on 1.5.2016 to take over the business of DEF and Co. from 1.1.2016. The Profit and Loss Account given by ABC Ltd for the year ended 31.12.2016 is as under:

Dr. Profit and Loss Account for the year ended 31.12.2016 Cr.

Particulars	₹	Particulars	₹
To Rent and Taxes	90,000	By Gross Profit	10,64,000
To Salaries including manager's Salary of ₹ 85,000	3,31,000	By Interest on Investment	36,000
To Carriage Outwards	14,000		
To Printing and Stationery	18,000		
To Interest on Debentures	25,000		
To Sales Commission	30,800		
To Bad Debts (related to Sales)	91,000		
To Underwriting Commission	26,000		
To Preliminary Expenses	28,000		
To Audit Fees	45,000		
To Loss on Sale of Investments	11,200		
To Net Profit	3,90,000		
	11,00,000		11,00,000

Prepare a Statement showing allocation of pre-incorporation and post-incorporation profits after considering the following information:

(i) G.P. ratio was constant throughout the year.

(ii) Sales for January and October were $1\frac{1}{2}$ times the average monthly sales while sales for December were twice the average monthly sales.

(iii) Bad Debts are shown after adjusting a recovery of ₹ 7,000 of Bad Debt for a sale made in July 2017.

(iv) Manager's salary was increased by ₹ 2,000 p.m. from 1.5.2016.

(v) All investments were sold in April 2016.

14. Green Ltd. was established on 1st August, 2013 and received the Certificate of Commencement of business on 1st November, 2013. The company bought the business of Purple & Co. with effect from 1st April, 2013.

From the following information for the year ended on 31st March, 2014, find out the profit available for dividends.

(i) Sales for the year ₹ 12,00,000 out of which sales upto 1st August, 2013 was ₹ 5,00,000.

(ii) Gross Profit for the year was ₹ 3,60,000.

(iii) Expenses shown in the Statement of Profit and Loss were as under :

	₹
Salaries	24,000
Rent	12,000
Audit fees	12,000
Directors' fees	9,600
Interest on Debenture	10,000
Commission	19,200
Depreciation	51,000
General Expenses	16,800
Bad Debts (₹ 1,000 prior to incorporation)	3,000

[C.S. (Inter) — June, 2016]

Guide to Answers

Multiple Choice

1. C; 2. C; 3. A; 4. B; 5. B.

Practical Questions

1. **Profit prior to incorporation — ₹ 10,000; Post-incorporation profit — ₹ 21,400.**
2. **Profit prior to incorporation — ₹ 20,850; Post-incorporation profit — ₹ 19,250.**
3. **Profit prior to incorporation — ₹ 23,667; Post-incorporation profit — ₹ 90,333.**
4. **Profit prior to incorporation — ₹ 6,522; Post-incorporation profit — ₹ 32,878.**
5. **Profit prior to incorporation — ₹ 1,28,000; Post-incorporation profit — ₹ 8,72,000; Balance Sheet total — ₹ 88,72,000.**
6. **Profit prior to incorporation — ₹ 3,625; Post-incorporation profit — ₹ 7,475.**

7. **Capital Reserve — ₹ 5,408; Goodwill — ₹ 54,000; Balance Sheet — ₹ 1,55,950.**
8. **Profit prior to incorporation — ₹ 1,834; Post-incorporation Profit — ₹ 4,745.**
9. **Profit prior to incorporation — ₹ 496; Post-incorporation Profit — ₹ 3,374.**
10. **Profit prior to incorporation — ₹ 26,000; Post-incorporation Profit — ₹ 69,000;**
    Balance Sheet total — ₹ 4,02,000.
11. **Profit prior to incorporation — ₹ 9,250; Post-incorporation Profit — ₹ 26,250; Balance Sheet total — ₹ 3,02,750.**
12. **Closing Balance of Debtors is ₹ 1,52,000.**
    Goodwill ₹ 18,000.
    Profits prior to incorporation — ₹ 2,625.
    Post incorporation profit — ₹ 28,875.
13. **Profit prior to incorporation — ₹ 1,71,900; Post-incorporation profit — ₹ 2,18,100.**
14. **Profit available for dividend — ₹ 1,09,000.**

15

Liquidation of Companies

Meaning of Winding Up and Liquidation

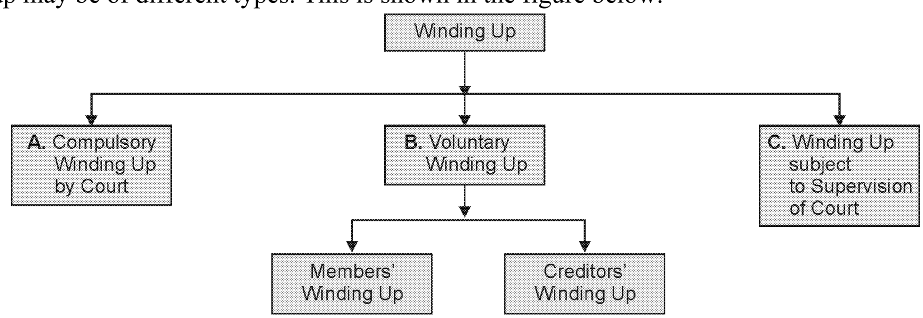
A company is formed by law and its existence can be terminated also by law. Winding up or liquidation is the process by which the management of a company's affairs is taken out of its directors' hands. Its directors usually become defunct. A 'Liquidator' is appointed as administrator.

The assets of the company are realised by a liquidator and its liabilities are paid off by him. If any money is left after paying company's debts, the surplus is distributed among the members of the company. This process may be resorted to irrespective of the fact whether the company is solvent or insolvent.

From the date of commencement of the winding up, a liquidator is appointed to conduct the dissolution of the company and the company ceases to be a going concern. The legal process through which a company is wound up, is called ***liquidation***. The two terms '***winding up***' and '***liquidation***' can be used interchangeably.

Modes of Winding Up

Winding up may be of different types. This is shown in the figure below.



***It may be noted that different sections related to Liquidation as per Companies Act, 2013 have not been notified till 30th November, 2016. Therefore, the relevant sections of the Companies Act, 1956 are applicable at present.*.**

A. Compulsory Winding Up by Court

A compulsory winding up takes place when a company is directed to be wound up by an order of Court. A company may be wound up by the Court under the following circumstances :

(i) If the company has by ***special resolution*** resolved that the company be wound up by Court.
(ii) If ***default*** is made in delivering the statutory report to the registrar or in holding the statutory meeting.
(iii) If the company ***does not commence its business*** within a year from its incorporation, or ***suspends its business*** for a whole year.
(iv) If the number of ***members is reduced*** in the case of a public limited company to below 7 and in the case of a private company below 2.
(v) If the company is unable to pay ***its debts***.
(vi) If the Court is of opinion that it is ***just and equitable*** that the company should be wound up.

Application for Winding Up

An application for the winding up of a company can be made to the Court by :

(i) the company; or
(ii) any creditor or creditors, including any contingent or prospective creditor or creditors; or
(iii) any contributory or contributories; or
(iv) the Registrar; or
(v) any person authorised by the Central Government (in a case falling under section 243).

(i) Company : A company can apply in the Court for winding up, if the shareholders pass a ***special resolution*** that the company be wound up by the Court, not otherwise.

(ii) Creditors : Creditors usually apply for winding up on the ground that the company is unable to pay its debts. The Court will not order winding up if the claim is doubtful or if the company can show good grounds for non-payment.

(iii) Contributory : A contributory may present a petition for winding up of the company irrespective of the fact whether he is a holder of partly paid-up shares or fully paid-up shares. A contributory is a person liable to contribute to the assets of a company in the event of its being wound up. If the number of members of a company has fallen below two in the case of a private limited company or below seven in case of public limited company, any contributory can apply for its compulsory winding up.

(iv) Registrar : The Registrar is entitled to apply for winding up. However, he must obtain the previous sanction of the Central Government.

(v) Government : The Central Government can apply for winding up, if such action is considered necessary after an enquiry into the affairs of the company by inspectors.

Hearing of the Petition

After a winding up petition is filed, notice is issued on the company to appear and state its case if any. After hearing both sides, the court may —

(a) dismiss it, with or without cost; or
(b) adjourn the hearing conditionally or unconditionally; or
(c) make an interim order that it thinks fit; or
(d) make an order for winding up of the company.

The winding up is deemed to commence from the date of ***presentation of the petition for winding up***, although the order of compulsory winding up is passed on a later date.

The Court appoints a liquidator whose function is to take charge of and complete the winding up proceedings. The Official Receiver ***attached*** to the Court becomes the official liquidator. The Court may also appoint a Provisional Liquidator at any time after the filing of the petition and before the passing of an order for compulsory winding up. It is done where the protection of the assets of the company is deemed to be matter of emergency. When an official liquidator is appointed, the provisional liquidator's office is terminated.

Steps in Liquidation

The different steps that have to be taken in connection with compulsory winding up by Court are as follows:

1. Within ***one month*** of the passing of the order for winding up, the petitioners must file a copy of the order with the Registrar of Companies.
2. Within ***21 days*** from the date of passing the winding up order (if provisional liquidator is appointed then from the date of appointment of such liquidator), the ***directors and chief officers*** of the company must submit to the liquidator a ***'Statement of Affairs'*** of the company.
3. Within ***one month*** of the winding up order, the liquidator must call a meeting of the creditors of the company for determining whether a Committee of Inspection should be appointed to work with the liquidator.
4. Within ***four months*** from the date of passing winding up order, the liquidator must file a ***'Preliminary Report'*** in the Court showing: (a) capital; (b) particulars of assets; (c) estimated amount of liabilities; (d) causes of failure of company; and (e) whether any further enquiry is necessary.
5. ***List of contributories*** has to be prepared by the liquidator and get it settled by the Court.
6. ***List of creditors*** has to be prepared by the liquidator to ascertain the debts due by the company.
7. If the liquidation is not complete within a year, the liquidator has to file a statement of his receipts and payments — known as '***Liquidator's Statement of Accounts***' at least twice in each year.
8. The liquidator has to file in Court a statement showing the position in liquidation once in every year (if the liquidation has not been completed within a year).
9. The liquidator declares and pays dividend to the creditors.
10. The liquidator distributes surplus (if any) among the shareholders in a proper and just manner.
11. When the process of winding up is completed, the Court passes an order that the company is dissolved as from the date of order.

B. Voluntary Winding Up

1. Voluntary winding up means winding up by the members themselves without the intervention of the Court. Section 484 of the Companies Act, 1956, provides that a company can be wound up voluntarily under the following circumstances:
   1. By an ***Ordinary Resolution*** of the members passed in a general meeting in the following cases:
      (a) where the duration of the company was fixed by articles of association and the period has expired; and
      (b) where the articles of association provided for winding up on the occurrence of any event and that event has occurred.
2. By a ***Special Resolution*** passed by the members in all other cases.

After passing the resolution for ***voluntary winding up***, it must be notified to the public by an advertisement in the '***Official Gazette***' and in a local newspaper.

There are two types of voluntary winding up :

(i) Members' Voluntary Winding Up; and

(ii) Creditors' Voluntary Winding Up.

If the company is, at the time of winding up, a solvent company and the directors make a declaration to that effect, it is called a ***Members' Voluntary Winding Up'.***

If the company is not in a position to pay its debts and the directors make no declaration of solvency, it is called a ***'Creditors' Voluntary Winding Up'***.

(i) Members' Voluntary Winding Up

The different steps that have to be taken in connection with Members Voluntary winding up are as follows :

1. The declaration of solvency is to be made by all the directors (where there are only two directors) or by the majority of the directors (where there are more than two directors).
2. Within ***5 weeks*** of declaration of solvency, a resolution in a general meeting is passed.
3. The company appoints one or more liquidators and fixes their remuneration in the general meeting.
4. Notice of the appointment of the liquidator is given to the Registrar.

5. Liquidator is collecting the company's assets and paying off the liabilities of the company. If there is any surplus, it is distributed among the members.
6. As soon as the affairs of the company are fully wound up, the liquidator shall call a meeting of the company (by advertisement in the local newspapers) and lay before its accounts showing how the winding up has been conducted.
7. Within ***one week*** after the meeting, the liquidator has to file with the Registrar the above account as also a return of the holding of the meeting. The Registrar, on receiving the accounts and the returns, shall register them.
8. After the expiry of ***three months*** from the date of registration, the company is deemed to have dissolved.

(ii) Creditors' Voluntary Winding Up

The different steps that have to be taken in connection with Creditors' Voluntary Winding Up are as follows:

1. The company calls an extraordinary general meeting for passing an extraordinary resolution of voluntary winding up.
2. The creditors' meeting is to be called on the same day or on the next following the day on which the general meeting of the company is held for passing resolution for voluntary winding up.
3. At the creditors' meeting one of the directors shall preside. The Board of Directors shall lay before the meeting:
   (i) a full statement of the position of the company's affairs; and
   (ii) a list of creditors of the company with the estimated amount of their claims.
4. Within ***ten days*** of the passing of the resolution at the creditors' meeting, the company shall give notice of the resolution to the Registrar of Companies.
5. The creditors and the company at their respective meetings may nominate a person to be liquidator for the purpose of winding up the affairs and distributing the assets of the company. If the creditors and The company nominate different persons, ***the person nominated by the creditors shall be the liquidator***.
6. The creditors may also appoint a Committee of Inspection if they so desire.
7. If the winding up process continues for more than a year, the liquidator has to prepare a statement of his receipts and payments at least twice a year. The liquidator shall call meetings of the shareholders and creditors separately at the end of each year to place before them a statement of the exact position in the winding up.
8. As soon as the affairs of the company are fully wound up, the liquidator is required to call a meeting of the shareholders, as well as a meeting of the creditors and lay before such meeting his final report and accounts.
9. Within ***one week*** after the date of the meetings, the liquidator has to file with the Registrar his final report and accounts, as also a return regarding the last meeting. The Registrar, on receiving the accounts and returns, shall register them.
10. After the expiry of ***three months*** from the date of registration, the company is deemed to have dissolved.

Winding Up Subject to Supervision of Court

At any time after a company has passed a resolution for voluntary winding up, the Court may make an order that the voluntary winding up shall continue but subject to the supervision of the Court.

The court may pass an order on the following grounds :

(i) the liquidator under voluntary liquidation is partial or is negligent in collecting the assets.
(ii) the rules regulating to winding up are not being observed.
(iii) the resolution for winding up was obtained by fraud.

The Court can appoint additional liquidator or liquidators. The Court can remove any liquidator and fill any vacancy caused by removal, death or registration. After a supervision order is passed, the Court can exercise all powers which it might have exercised if an order had been made for winding up by the court.

***It should be noted that after Companies (Second Amendment) Act, 2002 'winding up under supervision of the Court' is not there*.**

Preparation of Statement of Affairs and List

Where the Court has made a winding up order or appointed the official liquidator as provisional liquidator, the directors of the company must make available to the liquidator a statement as to the affairs of the company in the ***prescribed form***, verified by an affidavit, and containing the following particulars, namely:

(a) the assets of the company, stating separately the cash balance in hand and at the bank, if any, and the negotiable securities, if any, held by the company;

(b) its debts and liabilities;

(c) the names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts;

(d) the debts due to the company and the names, residences and occupations of the persons from whom they are due and the amount likely to be realised on account thereof.

The objective of preparation of statement of affairs is to give the liquidator a rough idea as to the financial position of the company. The statement of affairs is required in ***both compulsory and voluntary*** winding up. In case of compulsory winding up, the statement should be made within 21 days from the date of appointment of the provisional liquidator (or in the absence of such an appointment, from the date of commencement of winding up). The Court of the Official Liquidator has power to extend the time upto 3 months.

FORM No. 57

(See rule 127)

In the High Court at...

[(Or)] In the District Court of ....

Original Jurisdiction

In the matter of the Companies Act, 1956

and

In the matter of ....(Give the name of the Company (In liquidation)

Company Petition No. .... of 20........

Statement of Affairs under Section 454

Statement of affairs of the above-named company as on the .... day of 20................................ the date of the winding-up order [or the order appointing Provisional Liquidator or the date directed by the Official Liquidator].

I/We .... of .... do solemnly affirm and say that the statement made overleaf and the several lists hereunto annexed marked 'A' to 'I' are to the best of my/our knowledge and belief a full, true and complete statement as to the affairs of the above-named company, on the .... day of .... 20....... the date of the winding-up order [or the order appointing Provisional Liquidator or the date directed by the Official Liquidator], and that the said company carries/carried on the following business :

[Here set out nature of company's business.] Signature(s)

Solemnly affirmed at .... this .... day of .... 20 ....

Before me

Commissioner for Oaths

The commissioner is particularly requested, before swearing the affidavit, to ascertain that the full name, address and description of the deponent are stated, and to initial any crossings-out or other alterations in the printed form. A deficiency in the affidavit in any of the above respects will entail its refusal by the Court and will necessitate its being re-sworn.

NOTE : The several lists annexed are not exhibits to the affidavit.

STATEMENT OF AFFAIRS AND LISTS TO BE ANNEXED

Statement as to the affairs of .... Ltd. on the .... day of ....20......, being the date of the winding-up order (or order appointing Provisional Liquidator on the date directed by the Official Liquidator as the case may be) showing assets at estimated realisable values and liabilities expected to rank:—

Particulars	Estimated Realisable Values (₹)
Assets not specifically pledged (as per list 'A')	
Balance at Bank	
Cash in Hand	
Marketable Securities	
Bills Receivable	
Trade Debtors	
Loans and Advances	
Unpaid Calls	
Stock-in-trade	
Work-in-progress	
. . . . . .	
. . . . . .	
Freehold Property, Land and Buildings	
Leasehold Property	
Plant and Machinery	
Furniture, Fittings, Utensils, etc.	
Investments other than marketable securities	
Livestock	
Vehicles, etc.	
Other property, viz.	
. . . . . .	
. . . . . .	
***Assets specifically pledged (as per list 'B')**	

	(a) Estimated Realisable Value (₹)	(b) Due to Secured Creditors (₹)	(c) Deficiency Ranking as Unsecured (₹)	(d) Surplus carried to last column (₹)
Freehold Property				
₹				

Particulars	Estimated Realisable Values (₹)
Estimated surplus from assets specifically pledged	
Estimated total assets available for preferential creditors, debenture holders secured by a floating charge, and unsecured creditors** (carried forward)	₹
Summary of Gross Assets	

	(d) ₹.
Gross realisable value of assets specifically pledged	
Other Assets	
Gross Assets (₹)	

*Note : All assets specifically mortgaged, pledged or otherwise given as security should be included under this head. In the case of goods given as security, those in possession of the company and those not in possession should be separately set out.

	Estimated total assets available for preferential creditors, debenture holders secured by a floating charge, and unsecured creditors** (brought forward).	
	Liabilities	₹
(e) Gross Liabilities ₹	(to be deducted from surplus or added to deficiency as the case may be.) Secured creditors (as per List 'B') to the extent to which claims are estimated to be covered by assets specifically pledged [item(a) or (b) on preceding page, whichever is the less] (Insert in 'Gross Liabilities' column only) Preferential creditors (as per List 'C') . . . . Estimated balance of assets available for Debenture holders secured by a floating charge and unsecured creditors** . . . . ₹ Debenture Holders secured by a floating charge (as per List 'D').	

Estimated Surplus / Deficiency as regards Debenture Holders**.	
Unsecured Creditors (as per List 'E')	
Estimated unsecured balance of claims of creditors partly secured on specific assets, brought from preceding page(c)	
Trade Accounts.	
Bills Payable.	
Outstanding Expenses.	
Contingent Liabilities (state nature).	
Estimated Surplus / Deficiency as regards Creditors	
[Being difference between Gross Assets brought from preceding page (d) and Gross Liabilities as per column (e)]	
Issued and Called-up Capital :	
. . . preference shares of . . . each. . . called-up (as per List 'F')	
. . . equity shares of . . . each . . . called-up (as per List 'G')	
. . . .	
. . . .	
Estimated Surplus/Deficiency as regards Members** (as per List 'H')	

**These figures must be read subject to the following notes :

(1) (f) There is no unpaid capital liable to be called-up, or

(g) The nominal amount of unpaid capital liable to be called-up is ₹ . . . estimated to produce ₹ . . . which is/is not charged in favour of Debenture Holders (Strike out (f) or (g)).

(2) The estimates are subject to costs of the winding-up and to any surplus or deficiency on trading pending realisation of the assets.

The Statement of Affairs should accompany the following eight lists :

List 'A' — Assets Not Specifically Pledged

(Full particulars of every description of property not specifically pledged and not included in any other List are to be set forth in this list.)

List 'B' — Assets Specifically Pledged and Creditors Fullyor Partly Secured

(Not including Debenture Holders secured by a floating charge). The names of the secured creditors are to be shown against the assets on which their claims are secured, numbered consecutively, and arranged in alphabetical order as far as possible.)

List 'C' — Preferential Creditors For Rates, Taxes, Salaries, Wages and Otherwise

(The names to be arranged in alphabetical order and numbered consecutively)

List 'D' — List of Debenture Holders Secured By A Floating Charge

(The names to be arranged in alphabetical order and numbered consecutively. Separately Lists must be furnished of holders of each issue of Debentures, should more than one issue have been made.)

List 'E' — Unsecured Creditors

(The names to be arranged in alphabetical order and numbered consecutively.)

List 'F' — List of Preference Shareholders

(The names to be arranged in alphabetical order and numbered consecutively.)

List 'G' — List of Equity Shareholders

(The names to be arranged in alphabetical order and numbered consecutively.)

List 'H' — Deficiency or Surplus Account.

Illustration 1

Unstable Ltd. went into compulsory liquidation. Their summarised Balance Sheet as at 31st March, 2016 appears as under:

Liabilities	₹	Assets	₹
2,50,000 Equity Shares of ₹ 10 each	25,00,000	Land and Buildings	5,00,000
Secured Debentures (security Land and Buildings)	10,00,000	Other Fixed Assets	20,00,000
Unsecured Loans	20,00,000	Current Assets	45,00,000
Trade Creditors	35,00,000	Profit and Loss Account	20,00,000
	90,00,000		90,00,000

	₹
Contingent liabilities are :	
for Bills Discounted	1,00,000
for Excise duty demands	1,50,000

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

	₹
Land and Buildings	11,00,000
Other fixed Assets	18,00,000
Current Assets	35,00,000

Taking the above into account, prepare the Statement of Affairs.

Solution **Statement of Affairs of Unstable Ltd. as at 31st March, 2016** (all figures in Rupees)

Assets					Estimated Realisable Value
Assets not Specifically Pledged (as per List A)					
Other Fixed Assets					18,00,000
Current Assets					35,00,000
					53,00,000
Assets Specifically Pledged (as per List B)					
	(a) Estimated Realisable Value	(b) Due to Secured Creditors	(c) Deficiency Ranking as Unsecured Creditors	(d) Surplus Carried to Last Column	
Land and Buildings	11,00,000	10,00,000	—	1,00,000	
Estimated Surplus from Assets Specifically Pledged					1,00,000
Estimated Total Assets Available for Preferential Creditors, Debentureholders Secured by Floating Charge, and Unsecured Creditors					54,00,000
Summary of Gross Assets	₹				
Gross Realisable Value of Assets Specifically Pledged	11,00,000				
Other Assets	53,00,000				
Gross Assets	64,00,000				

Gross Liabilities	Liabilities	
	(To be deducted from surplus or added to deficiency as the case may be)	
10,00,000	Secured Creditors (as per List 'B') to the extent to which Claims are estimated to be covered by Assets specifically pledged	
1,50,000	*Preferential Creditors (as per List 'C')	1,50,000
	Estimated Surplus available for Unsecured Creditors	52,50,000
	Unsecured Creditors (as per List 'E')	
20,00,000	Unsecured Loans	20,00,000
35,00,000	Trade Creditors	35,00,000
1,00,000	Contingent Liability on Bills Discounted	1,00,000
67,50,000	**Estimated Deficiency as regard Creditors**	3,50,000
	(Being the difference between gross assets and gross liabilities, i.e., ₹ 64,00,000 – 67,50,000)	
	2,50,000 Equity Shares of ₹ 10 each (as per List 'G')	25,00,000
	Estimated Deficiency as regard Members	28,50,000

***Tutorial Note** : Contingent liabilities for excise demand will be treated as Preferential Creditors.

Illustration 2

X Co. Ltd. went into voluntary liquidation on 1st April, 2016. The following balances are extracted from its books on that date :

Liabilities	₹	Assets	₹
Share Capital :		Machinery	90,000
24,000 Equity Shares of ₹ 10 each	2,40,000	Leasehold Properties	1,20,000
Debentures (Secured by floating charge)	1,50,000	Stock	3,000
Overdraft	54,000	Debtors	1,50,000
Creditors	60,000	Investments	18,000
		Cash in Hand	3,000
		Profit and Loss Account	1,20,000
	5,04,000		5,04,000

The following assets are valued as under : ₹

Machinery 1,80,000

	₹
Leasehold Properties	2,18,000
Investments	12,000
Stock	6,000
Debtors	1,40,000

The bank overdraft is secured by deposit of title deeds of leasehold properties. There were preferential creditors of ₹ 3,000 which were not included in Creditors ₹ 60,000.

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

Solution **Statement of Affairs of X Co. Ltd. as at 1st April, 2016**

Gross Liabilities	Assets	(a) Estimated Realisable Value (₹)	(b) Due to Secured Creditors (₹)	(c) Deficiency Ranking as Unsecured Creditors (₹)	(d) Surplus Carried to Last Column (₹)	Estimated Realisable Value (₹)
	Assets not Specifically Pledged (as per List A)					
	Cash in Hand					3,000
	Investments					12,000
	Debtors					1,40,000
	Stock					6,000
	Machinery					1,80,000
						3,41,000
	Assets Specifically Pledged (as per List B)					
	Leasehold Property	2,18,000	54,000	—	1,64,000	
	Estimated Surplus from Assets Specifically Pledged					1,64,000
	Estimated Total Assets Available for Preferential Creditors, Debentureholders Secured by Floating Charge, and Unsecured Creditors					5,05,000
	Summary of Gross Assets ₹					
	Gross Realisable Value of Assets Specifically Pledged 2,18,000					
	Other Assets 3,41,000					
	Gross Assets 5,59,000					
	Liabilities					
Gross Liabilities	(To be deducted from surplus or added to deficiency as the case may be)					
54,000	Secured Creditors (as per List 'B') to the extent to which claims are estimated to be covered by Assets specifically pledged					
3,000	*Preferential Creditors (as per List 'C')					3,000
	Estimated Balance of Assets available for Debentureholders secured in Floating charge, and Unsecured Creditors					5,02,000
1,50,000	Debentures					1,50,000
	Estimated Surplus available for Unsecured Creditors					3,52,000
	Unsecured Creditors (as per List 'E')					
60,000	Creditors					60,000
2,67,000	**Estimated Surplus as regard Creditors**					2,92,000
	(Being difference between gross assets and gross liabilities, i.e. ₹ 5,59,000 – 2,67,000)					
	24,000 Equity Shares of ₹ 10 each (as per List 'G')					2,40,000
	Estimated Surplus as regards Members					52,000

Illustration 3

Bad Luck Ltd. went into compulsory liquidation on 30th June, 2016. From the following particulars prepare a Statement of Affairs in the present statutory form as far as possible :

Particulars	₹
Equity Share Capital — 20,000 Equity Shares of ₹ 10 each, ₹ 5 paid-up	1,00,000
7% Preference Share Capital — 20,000 Shares of ₹ 10 each fully paid	2,00,000
6% First Mortgage Deb. secured by a Floating Charge upon the whole of the assets of the company except un-called capital	1,50,000
Fully Secured Creditors (value of Securities ₹ 35,000)	30,000

Partly Secured Creditors (value of Securities ₹ 10,000)			20,000
Preferential Creditors for rent, taxes, salaries and wages			6,000
Bills Payable			1,00,000
Unsecured Creditors			70,000
Bank Overdraft			10,000
Bills Receivable in Hand			15,000
Bills Discounted (one bill for ₹ 10,000 estimated to be bad)			30,000
Investments in shares : Estimated value ₹ 35,000 (deposited with secured creditors)			50,000
G.P. Notes : estimated value ₹ 10,000 (deposited with partly secured creditors)			15,000
Book Debts :		₹	
Good		10,000	
Doubtful (estimated to produce 50 paisa in the rupee)	7,000		
Bad		6,000	23,000
Land and Building (estimated to produce ₹ 1,00,000)			1,50,000
Stock-in-trade (estimated to produce ₹ 40,000)			50,000
Machinery and Tools (estimated to produce ₹ 2,000)			5,000
Cash in Hand			100

Solution **Statement of Affairs of Bad Luck Ltd. as at 30th June, 2016**

Assets					Estimated Realisable Value (₹)
Assets not Specifically Pledged (as per List A)					
Cash in Hand					100
Bills Receivable					15,000
Trade Debtors					13,500
Stock-in-Trade					40,000
Land and Buildings					1,00,000
Plant and Machinery					2,000
					1,70,600
Assets Specifically Pledged (as per List B)					
	(a) Estimated Realisable Value (₹)	(b) Due to Secured Creditors (₹)	(c) Deficiency Ranking as Unsecured Creditors (₹)	(d) Surplus Carried to Last Column (₹)	
Investments in Shares	35,000	30,000	—	5,000	
G.P. Notes	10,000	20,000	10,000	—	
Estimated Surplus from Assets Specifically Pledged					5,000
Estimated Total Assets Available for Preferential Creditors / Debentureholders Secured by Floating Charge, and Unsecured Creditors carried forward					1,75,600
Summary of Gross Assets		₹			
Gross Realisable Value of Assets Specifically Pledged	45,000				
Other Assets		1,70,600			
Gross Assets		2,15,600			

Gross Liabilities	Liabilities	
	(To be deducted from surplus or added to deficiency as the case may be)	
40,000	Secured Creditors (as per List 'B') to the extent to which Claims are estimated to be covered by Assets specifically pledged	
6,000	Preferential Creditors (as per List 'C')	6,000
	Estimated Surplus available to Debentureholders secured by Floating charge, and Unsecured Creditors	1,69,600
1,50,000	Debentureholders secured by a Floating Charge (as per List 'D')	1,50,000
	Estimated Surplus available to Unsecured Creditors	19,600
	Unsecured Creditors (as per List 'E')	
10,000	Partly secured creditors (deficiency ranking as unsecured)	10,000
70,000	Unsecured creditors	70,000
1,00,000	Bills Payable	1,00,000
10,000	Bank Overdraft	10,000
10,000	Contingent Liability (for bills discounted)	10,000
3,96,000	**Estimated Deficiency as regards Creditors**	1,80,400
	[Being the difference between gross assets and gross liabilities i.e.₹ 2,15,000 -₹ 3,96,000]	

	20,000 Preference Shares of ₹ 10 each fully called-up (as per List 'F')	2,00,000
	20,000 Equity Shares of ₹ 10 each, ₹ 5 called-up	1,00,000
	Estimated Deficiency as regards Members (as per List 'H')	4,80,400

Illustration 4

A winding up order has been issued against M Ltd.

The following information is obtained with regard to the assets and liabilities as on 30 June, 2016:

Particulars	₹	Particulars	₹
Freehold premises (book value ₹ 4,50,000) valued at	3,75,000	Bank loan — unsecured	58,125
First mortgage of freehold premises	3,00,000	Cash in Hand	825
Second mortgage of freehold premises	1,12,500	Stock (at cost ₹ 50,850) estimated to realise	33,900
8% debentures carrying a floating charge on the undertaking, interest due 1st September and 1st April and paid on due dates	1,50,000	Issued Capital : Equity Shares of ₹ 10 each fully called-up	1,50,000
		Calls-in-arrears, ₹ 3,000 estimated to realise	1,500
Managing Director's emoluments (6 months)	22,500	Unsecured creditors	2,96,250
Staff salary unpaid (one month)	16,050	Contingent liability in respect of a claim for damages ₹ 37,500 — estimated to be settled for	18,000
Trade debtors — Good	31,500		
Doubtful (estimated to realise 50%)	12,900	Income-tax liability	
Bad	72,750	For 30 June, 2014	5,250
Plant and machinery (book value ₹ 2,47,500)		For 30 June, 2015	1,275
estimated to realise	1,74,000	For 30 June, 2016	2,700

The Reserves of the company on 1st July 2015 amounted to ₹ 7,500.

You are required to prepare :

(i) Statement of Affairs, and (ii) Deficiency Account.

Solution **Statement of Affairs of M Ltd. as at 30th June, 2016**

Assets					Estimated Realisable Value (₹)
Assets not Specifically Pledged (as per List A)					
Cash in Hand					825
Trade Debtors (₹ 31,500 + 50% of ₹ 12,900)					37,950
Unpaid Calls					1,500
Stock					33,900
Plant and Machinery					1,74,000
					2,48,175
Assets Specifically Pledged (as per List B)					
	(a) Estimated Realisable Value (₹)	(b) Due to Secured Creditors (₹)	(c) Deficiency Ranking as Unsecured Creditors (₹)	(d) Surplus Carried to Last Column (₹)	
Freehold Premises	3,75,000	3,00,000	—	—	
Second Mortgage on above	—	1,12,500	37,500	—	—
Estimated Total Assets Available for Preferential Creditors / Debentureholders Secured by Floating Charge, and Unsecured Creditors carried forward					2,48,175
Summary of Gross Assets		₹			
Gross Realisable Value of Assets Specifically Pledged		3,75,000			
Other Assets		2,48,175			
Gross Assets		6,23,175			

Gross Liabilities	Liabilities	
	(To be deducted from surplus or added to deficiency as the case may be)	
3,75,000	Secured Creditors (as per List 'B') to the extent to which Claims are estimated to be covered by Assets specifically pledged	
20,025	Preferential Creditors (as per List 'C') [Note 2]	20,025
	Estimated Surplus available to Debentureholders secured by Floating charges, and Unsecured Creditors	2,28,150
1,53,000	Debentureholders secured by a Floating Charge (as per List 'D') [₹ 1,50,000 + ₹ 3,000 (interest)]	1,53,000
	Estimated Surplus available to Unsecured Creditors	75,150
	Unsecured Creditors (as per List 'E')	
37,500	Partly secured creditors (deficiency ranking as unsecured)	37,500

2,96,250	Unsecured Creditors	2,96,250
27,750	Outstanding Director's Emoluments and Taxes (₹ 22,500 + ₹ 5,250)	27,750
58,125	Bank Overdraft	58,125
18,000	Contingent Liability in respect of a Claim for Damages	18,000
9,85,650	**Estimated Deficiency as regard Creditors**	3,62,475
	15,000 Equity Shares of ₹ 10 each fully called up less calls in arrears ₹ 1,500	1,48,500
	Estimated Deficiency as regards Members (as per List H)	5,10,975

List H — Deficiency Account

		₹
A. Items contributing to Deficiency		
1. Excess of Capital and Liabilities over assets on 1st July, 2015		—
2. Dividend and Bonus declared		—
3. Net trading losses after charging depreciation, taxation, interest on debentures, etc. (Note 1)		2,55,825
4. Losses other than trading losses		—
5. Estimated losses now written off :	₹	
Freehold Premises	75,000	
Trade Debtors	79,200	
Plant and Machinery	73,500	
Stock	16,950	
Claim for Damages	18,000	2,62,650
6. Any other item		—
		5,18,475
B. Items Reducing Deficiency		
7. Excess of Assets over Capital and Liabilities as on 1st July, 2015		7,500
8. Net Trading Profit		—
9. Profits and Incomes other than Trading Profit		—
10. Other Items		—
Deficiency as explained in the Statement of Affairs		5,10,975

Working Notes : **(1) Balance Sheet as at 30th June, 2016**

Liabilities	₹	Assets	₹
15,000 Equity Shares of ₹ 10 each	1,50,000	Freehold Premises	4,50,000
Less: Calls-in-Arrears	3,000	Plant and Machinery	2,47,500
	1,47,000	Sundry Debtors (₹ 31,500 + 12,900 + 72,750)	1,17,150
Reserve — 1.7.2015	7,500	Stock	50,850
1st Mortgage	3,00,000	Cash	825
2nd Mortgage	1,12,500	Profit and Loss Account	2,55,825
8% Debentures	1,50,000		
Interest on Debentures for 3 months	3,000		
Unsecured Creditors	2,96,250		
Director's Remuneration due	22,500		
Staff Salary Outstanding	16,050		
Bank Loan	58,125		
Liability for I.T.	9,225		
	11,22,150		11,22,150

(2) Preferential Creditors

	₹
Income-tax : 2014-15	1,275
2015-16	2,700
Staff Salary	16,050
	20,025

It should be noted that the tax which becomes payable within 12 months of the relevant date will be preferential claim even though it relates to an earlier period.

(3) Managing Director's remuneration has not been classified as preferential creditors as he is an officer and not an employee.

Liability of Present and Past Members

When a company is wound up, the present and past shareholders (known as contributories) shall be liable to contribute to the assets of the company so as to enable it to discharge its liabilities, meet the cost of liquidation and adjust the rights of contributories among themselves.

The list of contributories is made up of two parts, A and B. The 'A' list contains the names of persons who are members of a period of one year prior to the date of winding up.The 'B' list contains the name of persons who were members with a period of one year prior to the date of winding up.

The Court settles the list of contributories. The rights and liabilities of different contributories are determined by the Court as per the provision of the Companies Act, 1956. Section 426 provides as follows:

1. A past member shall not be liable to contribute if he has ceased to be a member for ***one year and upwards*** before the commencement of the winding up.
2. A past member is not liable in respect of any liability or debt of the company incurred ***after*** he ceased to be a member.
3. A past member is not liable to contribute unless the present members have been called upon to contribute to the fullest extent to which they can be so asked.
4. In the case of a company limited by shares, a contributory cannot be asked to pay more than the unpaid amount on the shares held by him.
5. In the case of a company limited by guarantee, a contributory cannot be asked to pay more than the amount undertaken to be contributed by him.

In this respect, the following two matters are important :
(i) Upon the death of a contributory, his legal representative becomes a contributory — Section 430.
(ii) In case of insolvency, the contribution due can be proved as a debt in the insolvency proceedings — Section 431.

Adjustment of Rights of Contributories

After paying off all the liabilities, if there is any surplus, it will be paid to the shareholders of the company in liquidation. In case of compulsory winding up, the Court fixes the respective rights of the contributories among themselves and surplus is distributed accordingly. In the case of voluntary winding up, preference shareholders are paid off first in respect of capital and arrears of dividend.

When equity shares are partly paid up and creditors or preference shareholders have not been paid, call will be made on them to pay the required amount. If there are fully paid up shares and partly paid up shares, suitable amounts have to be called up to make sacrifices equal or proportionate when the shares are of different denominations.

Illustration 5

M/s ABC Limited has gone into liquidation on 25th June, 2017. Certain creditors could not receive payments out of realisation of assets and contributions from A list contributories. The following are the details of certain transfers which took place in the year ended 31st March, 2017 :

Shareholders	Number of Shares Transferred	Date of Ceasing to be a Member	Creditors Remaining Unpaid and Outstanding on the Date of Such Transfer (₹)
P	4,000	10-05-2016	9,000
Q	3,000	22-07-2016	12,000
R	2,400	15-09-2016	13,500
S	1,600	14-12-2016	14,000
T	1,000	09-03-2017	14,200

All the shares are of ₹ 10 each, ₹ 8 per share paid-up. Show the amount to be realised from the persons listed above. Ignore remuneration to liquidator and other expenses.

Solution **Statement of Liability of B List Contributories**

Creditors Outstanding on the Date of Transfer (Ceasing to be Member)			Q	R	S	T	Amount to be Paid to Creditors
Date	₹	₹	₹	₹	₹	₹	₹
22.7.2016	—	12,000 (Note 2)	4,500	3,600	2,400	1,500	12,000
15.9.2016	13,500 (12,000)	1,500	—	720	480	300	1,500
14.12.2016	14,000 (13,500)	500	—	—	308	192	500

9.3.2017	14,200 (14,000)	200 (Note 5)	—	—	—	*200	*8
Total (a)		14,200	4,500	4,320	3,188	2,192	14,008
Number of Shares held		(No.)	3,000	2,400	1,600	1,000	
Maximum Liability on Shares held (b)		(₹)	6,000	4,800	3,200	2,000	
Amount Paid, lower of (a) and (b)		(₹)	4,500	4,320	3,188	2,000	14,008

*T's total liability is ₹ 2,192 but he will be called upon to pay ₹ 2,000 only. The loss of ₹ 192 will have to be suffered by the creditors. Therefore, ₹ 200 – ₹ 192 = ₹ 8 will be available.

Working Notes :

(1) P has transferred his shares prior to one year preceding the date of winding up. Therefore, P will not be liable to pay anything.

(2) The amount of ₹ 12,000 outstanding on 22.7.2016 will be contributed by Q, R, S and T in ratio of number of shares held by them, i.e., 3000 : 2400 : 1600 : 1000 or 30 : 24 : 16 : 10.

	₹
Q's share = $\frac{12,000}{80} \times 30$	4,500
R's share = $\frac{12,000}{80} \times 24$	3,600
S's share = $\frac{12,000}{80} \times 16$	2,400
T's share = $\frac{12,000}{80} \times 10$	1,500
	12,000

(3) The amount of ₹ 1,500 further debt incurred between 22.7.2016 and 15.9.2016 will be contributed by R, S and T in the ratio of number of shares held by them, i.e., 2400 : 1600 : 1000 or 24 : 16 : 10 or 12 : 8 : 5.

	₹
R's share = $\frac{1,500}{25} \times 12$	720
S's share = $\frac{1,500}{25} \times 8$	480
T's share = $\frac{1,500}{25} \times 5$	300
	1,500

(4) The amount of ₹ 500 further debt incurred between 15.9.2016 and 14.12.2016 will be contributed by S and T in the ratio of number of shares held by them, i.e., 1600 : 1000 or 8 : 5.

	₹
S's share = $\frac{500}{13} \times 8$	308
T's share = $\frac{500}{13} \times 5$	192
	500

(5) The amount of ₹ 200 further debt incurred after 14.12.2016 will be borne by T only.

Illustration 6

Liquidation of YZ Ltd. commenced on 2nd April, 2017. Certain creditors could not receive payments out of the realisation of assets and out of the contributions from 'A' list contributions. The following are the details of certain transfers which took place in 2016 and 2017 :

Shareholders	Number of Shares Transferred	Date of Ceasing to be a Member	Creditors Remaining Unpaid and Outstanding on the Date of Such Transfer (₹)
A	2,000	1st March, 2016	5,000
P	1,500	1st May, 2016	3,300
Q	1,000	1st October, 2016	4,300
R	500	1st November, 2016	4,600
S	300	1st February, 2017	6,000

All the shares were of ₹ 10 each, ₹ 8 per share paid up. Show the amount to be realised from the various persons listed above ignoring expenses and remuneration to liquidator etc.

Solution **Statement of Liability of B List Contributories**

Creditors Outstanding on the Date of Transfer (Ceasing to be Member)			P	Q	R	S	Amount to be Paid to Creditors
Date	₹	₹	₹	₹	₹	₹	₹
1.5.2016	—	3,300 (Note 2)	1,500	1,000	500	300	3,300
1.10.2016	4,300 (3,300)	1,000 (Note 3)	—	556	278	166	1,000
1.11.2016	4,600 (4,300)	300 (Note 4)	—	—	188	112	300
1.2.2017	6,000 (4,600)	1,400 (Note 5)	—	—	—	1,400	22*
Total (a)		6,000	1,500	1,556	966	1,978	4,622
Number of Shares held		(No.)	1,500	1,000	500	300	
Maximum Liability on Shares held (b)		(₹)	3,000	2,000	1,000	600	
Amount Paid, lower of (a) and (b)		(₹)	1,500	1,556	966	600	

*S's total liability is ₹ 1,978 but he can be called upon to pay only ₹ 600. The loss of ₹ 1,378 will have to be suffered by the creditors. Therefore, ₹ 1,400 – ₹ 1,378 = ₹ 22 will be available.

Working Notes :

(1) A has transferred his shares prior to one year preceding the date of winding up. Therefore, A will not be liable to pay anything.

(2) The amount of ₹ 3,300 outstanding on 1st May, 2016 will be contributed by P, Q, R and S in the ratio of number of shares held by them, i.e., 1500 : 1000 : 500 : 300 or 15 : 10 : 5 : 3.

	₹
P's share = $\frac{3,300}{33} \times 15$	1,500
Q's share = $\frac{3,300}{33} \times 10$	1,000
R's share = $\frac{3,300}{33} \times 5$	500
S's share = $\frac{3,300}{33} \times 3$	300
	3,300

(3) The amount of ₹ 1,000 further debts incurred between 1.5.2016 and 1.10.2016 will be contributed by Q, R and S (P is not liable) in the ratio of number of shares held by them, i.e., 10 : 5 : 3.

	₹
Q's share = $\frac{1,000}{18} \times 10$	556
R's share = $\frac{1,000}{18} \times 5$	278

S's share = $\frac{1,000}{18} \times 3$ 166

$\overline{\underline{1,000}}$

(4) The amount of ₹ 300 further debts incurred between 1.10.2016 and 1.11.2016 will be contributed by R and S in the ratio of number of shares held by them, i.e., 5 : 3. ₹

R's share = $\frac{300}{8} \times 5$ 188

S's share = $\frac{300}{8} \times 3$ 112

$\overline{\underline{300}}$

(5) The amount of ₹ 1,400 further debts incurred after 1.1.2016 will be borne by S only.

Illustration 7

Pessimist Ltd. has gone into liquidation on 10th May, 2017. The details of members, who have ceased to be members within the year 31st March, 2017 are given below.

Shareholders	Number of Shares Transferred	Date of Transfer	Proportionate Unpaid Debts (₹)
P	1,000	20.04.2016	3,000
Q	1,200	15.05.2016	5,000
R	1,500	18.09.2016	9,200
S	800	24.12.2016	10,500
T	500	12.03.2017	11,000

The debts that could not be paid out of realisation of assets and contribution from present members ('A' Contributories) are also given with their date-wise break-up. Shares are of ₹ 10 each, ₹ 6 per share paid-up.

You are to determine the amount realisable from each person.

Solution **Statement of Liability of B List Contributories**

Creditors Outstanding on the Date of Transfer (Ceasing to be Member)			Q	R	S	T	Amount to be Paid to Creditors
Date	₹	₹	₹	₹	₹	₹	₹
15.05.2016	—	5,000 (Note 2)	1,500	1,875	1,000	625	5,000
18.09.2016	9,200 (5,000)	4,200 (Note 3)	—	2,250	1,200	750	4,200
24.12.2016	10,500 (9,200)	1,300 (Note 4)	—	—	800	500	1,300
12.03.2017	11,000 (10,500)	500 (Note 5)	—	—	—	500	125*
Total (a)		11,000	1,500	4,125	3,000	2,375	10,625
Number of Shares held			1,200	1,500	800	500	
Maximum Liability on Shares held (b)		(₹)	4,800	6,000	3,200	2,000	
Amount Paid, lower of (a) and (b)		(₹)	1,500	4,125	3,000	2,000	

*T's total liability is ₹ 2,375 but he can be called upon to pay only ₹ 2,000. The loss of ₹ 375 will have to be suffered by the creditors. Therefore, ₹ 500 – ₹ 375 = ₹ 125 will be available.

Working Notes :

(1) P has transferred his shares prior to one year preceding the date of winding up. Therefore, P will not be liable to pay anything.

(2) The amount of ₹ 5,000 outstanding on 15th May, 2016 will be contributed by Q, R, S and T in the ratio of number of shares held by them, i.e., 12 : 15 : 8 : 5. ₹

Q's share = $\frac{5,000}{40} \times 12$ 1,500

R's share = $\frac{5,000}{40} \times 15$	1,875
S's share = $\frac{5,000}{40} \times 8$	1,000
T's share = $\frac{5,000}{40} \times 5$	625
	5,000

(3) The amount of ₹ 4,200 further debts incurred between 15.5.2016 and 18.9.2016 will be contributed by R, S and T only (Q is not liable) in the ratio of number of shares held by them i.e., 15 : 8 : 5.

	₹
R's share = $\frac{4,200}{28} \times 15$	2,250
S's share = $\frac{4,200}{28} \times 8$	1,200
T's share = $\frac{4,200}{28} \times 5$	750
	4,200

(4) The amount of ₹ 1,300 further debts incurred between 18.9.2016 and 24.12.2016 will be contributed by S and T only (R is not liable) in the ratio of number of shares held by them, i.e., 8 : 5.

	₹
S's share = $\frac{1,300}{13} \times 8$	800
T's share = $\frac{1,300}{13} \times 5$	500
	1,300

(5) The amount of ₹ 500 further debts incurred after 24.12.2016 will be contributed by T only.

Illustration 8

In a winding up of a company, certain creditors remained unpaid. The following persons had transferred their holding sometimes before winding up.

Name	Date of Transfer	Number of Shares Transferred	Amount Due to Creditors on the Date of Transfer (₹)
P	January 1, 2016	1,000	7,500
Q	February 15, 2016	400	12,500
S	March 15, 2016	700	18,000
T	March 31, 2016	900	21,000
U	April 5, 2016	1,000	30,000

The shares were of ₹ 100 each, ₹ 80 being called-up and paid-up on the date of transfers.

A member, R, who held 200 shares died on 28th February, 2016 when the amount due to creditors was ₹ 15,000. His shares were transmitted to his son X. Z was the transferee of shares held by T. Z paid ₹ 20 per share as calls in advance immediately on becoming a member.

The liquidation of the company commenced on 1st February, 2017 when the liquidator made a call on the present and the past contributories to pay the amount.

You are asked to quantify the maximum liability of the transferors of shares mentioned in the above table, when the transferees: (i) pay the amount due as 'present' member contributors; and (ii) do not pay the amount due as 'present' member contributories.

Also quantify the liability of X to whom shares were transmitted on the demise of his father, R.

Solution

(i) The transferors are P, Q, S, T and U. When the transferees pay the amount due as 'present' member contributories, there will not be any liability of transferors.

(ii) When the transferee do not pay the amount due as 'present' member contributories, the liability of the past member will be calculated as follows :

Statement of Liability as Contributories of Past Members

Creditors Outstanding on the Date of Transfer (Ceasing to be Members)			Q	R/X	S	U	Amount to be Paid to Creditors
Date	₹	₹	₹	₹	₹	₹	₹
15.02.2016	—	12,500 (Note 3)	2,174	1,087	3,804	5,435	12,500
28.02.2016	15,000 (12,500)	2,500 (Note 4)	—	263	921	1,316	2,500
15.03.2016	18,000 (15,000)	3,000 (Note 5)	—	316	1,105	1,579	3,000
05.04.2016	30,000 (18,000)	12,000	—	2,000	—	10,000	12,000
Total (a)		30,000	2,174	3,666	5,830	18,330	30,000
Number of Shares held			400	200	700	1,000	
Maximum Liability on Shares held (b)		(₹)	8,000	4,000	14,000	20,000	
Amount Paid, lower of (a) and (b)		(₹)	2,174	3,666	5,830	18,330	

Working Notes :

(1) P has transferred his shares prior to one year preceding the date of winding up. Therefore, P will not be liable to pay anything.

(2) T also will not be liable to pay anything as the transferee Z has paid the balance ₹ 20 per share as calls-in-advance.

(3) The amount of ₹ 12,500 outstanding on 15th February, 2016 will be contributed by Q, R, S and U in the ratio of number of shares held by them, i.e., 400 : 200 : 700 : 1000 or 4 : 2 : 7 : 10.

	₹
Q's share = $\frac{12,500}{23} \times 4$	2,174
R's share = $\frac{12,500}{23} \times 2$	1,087
S's share = $\frac{12,500}{23} \times 7$	3,804
U's share = $\frac{12,500}{23} \times 10$	5,435
	12,500

(4) The amount of ₹ 2,500 further debts incurred between 15.2.2016 and 28.2.2016 will be contributed by R/X, S and U in the ratio of number of shares held by them, i.e., 2 : 7 : 10.

	₹
R/X's share = $\frac{2,500}{19} \times 2$	263
S's share = $\frac{2,500}{19} \times 7$	921
U's share = $\frac{2,500}{19} \times 10$	1,316
	2,500

(5) The amount of ₹ 3,000 further debts incurred between 28.2.2016 and 15.3.2016 will be contributed by R/X, S and U in the ratio of number of shares held by them, i.e., 2 : 7 : 10.

	₹
R/X's share = $\frac{3,000}{19} \times 2$	316
S's share = $\frac{3,000}{19} \times 7$	1,105
U's share = $\frac{3,000}{19} \times 10$	1,579
	3,000

(6) Amount of ₹ 12,000 further debts incurred between 15.3.2016 and 5.4.2016 will be contributed by R/X and U in the ratio of number of shares held by them, i.e., 200 : 1,000 or 1 : 5.

	₹
R/X's share = $\frac{12,000}{6} \times 1$	2,000
U's share = $\frac{12,000}{6} \times 5$	10,000
	12,000

(7) R's 200 shares were transmitted to X on the death of R. As per the provision of Section 430, upon the death of a contributory, his legal representative becomes a contributory. So X is liable to contribute maximum (200 × ₹ 20) = ₹ 4,000.

Payments and Their Order

Money collected from realisation of the assets of a company in liquidation, are first applied for paying creditors and workmen. After paying creditors and workmen in full, the shareholders may get some money by way of return of capital.

If the company in liquidation is a solvent company (i.e., its assets > its liabilities), all its creditors will be paid off in full. In this case, the order in which the creditors are paid is not important. But if the company is not solvent, all creditors cannot be fully paid-off. In this case, the order in which the creditors is to be paid off is ***very very important***. The liquidator assumes that every company in liquidation to be insolvent till contrary is proved.

To be on the safer side, the liquidator usually adopts the same order in paying the creditors of every company in liquidation, as would be applicable to an insolvent company.

The order of priority in paying off creditors are as follows:

1. Workmen's dues and debts due to secured creditors.
2. Cost of liquidation :
   (i) Expenses of litigation
   (ii) Other expenses
   (iii) Remuneration of liquidators.
3. Preferential creditors.
4. Debenture having floating charge on assets.
5. Unsecured creditors.

Workmen's Dues and Debts Due to Secured Creditors

By the insertion of Section 529A and modification of Section 530, the workmen of the company in liquidation have been made secured creditors in respect of their claims for wages, salary, holiday remuneration, moneys receivable under Provident Fund, Pension Fund, Gratuity Fund, etc. The workmen will be secured creditors ranking *pari passu* with the charge of other secured creditors. If the securities given to the creditors do not fetch adequate value for payment in full all the dues of the secured creditors and the workmen, then the sale proceeds of securities will be distributed among the secured creditors and workmen proportionately.

For example :

(i) Workmen's dues ₹ 1,00,000

(ii) Secured creditors' dues ₹ 3,00,000

(iii) Proceeds from sale of securities ₹ 1,00,000

The proceeds of ₹ 1,00,000 will be distributed among workmen and secured creditors in the ratio of 1,00,000 : 3,00,000 or 1 : 3.

$$\text{Workmen will get } \frac{1,00,000}{4} \times 1 = 25,000$$

$$\text{Secured Creditors will get } \frac{1,00,000}{4} \times 3 = 75,000$$

Unpaid portion of the claim of the secured creditors (here ₹ 2,25,000) or the amount paid to workmen out of the realisation of the securities (here ₹ 25,000) whichever is less (i.e., ₹ 25,000) shall have a preferential claim over other creditors of the company. Similarly, the workmen's claim to the extent it has not been paid (i.e., ₹ 75,000) out of realisation of the securities should also rank *pari passu* with the said balance claim of the secured creditors. If the realisation of other assets of the company in liquidation is not adequate for payment in full the secured creditors' said claims of ₹ 25,000 and the workmen's unpaid portion of ₹ 75,000 then the sale proceeds would be distributed among them proportionately, i.e., 25,000 : 75,000. Subject to such payment of ₹ 25,000 to the secured creditors and ₹ 75,000 to workmen the ***preferential payment*** as provided in Section 530 would apply.

Secured creditors of a company in liquidation have the following alternatives :

(i) Sell the security and prove in the winding up for the balance of his debt after deducting the amount realised; or

(ii) Surrender the security to the liquidator and prove for the whole of his debt as an ***unsecured*** creditors; or

(iii) Estimate the value of his security and prove for the balance of his debt after deducting the estimated value; or

(iv) Rely on his security and not prove in the winding up. If there is any surplus, it will have to be handed over to the liquidator.

Cost of Liquidation

After secured creditors, cost of liquidation is paid. In case of a compulsory winding up, the Court may fix priority as regard the various items of cost *inter se*. In case of a voluntary winding up, the following order is generally adopted :

(i) Cost of litigation.

(ii) All other expenses including remuneration of solicitor and income tax on income accruing ***after*** the winding up order (e.g., capital gain tax on sale of different assets). However, income tax on income accruing ***before*** this date comes under preferential debt.

(iii) Remuneration of liquidator.

Preferential Creditors

The secured creditors' and workmen's claims come first, then comes cost, charges and expenses of the winding up. Whatever assets and moneys are left thereafter will be applied in paying the following debts as '***Preferential Debts***'.

(i) All revenues, taxes, cesses and rates due to Central Government or State Government or local authorities. The amount should have become due and payable within 12 months before the winding up order.

(ii) Wages or salaries of an employee for four months. The wages or salary for four months must be due within 12 months next preceding to ***relevant date***. The amount shall not exceed such sum as may be notified by the Central Government (presently ₹ 20,000) for any one claimant.

(iii) Accrued holiday remuneration which has become payable to an employee or in case of his death to any other person.

(iv) All amounts due in respect of contributions payable by the company as employer under any law. However, this is not payable if the company is being voluntarily wound up for reconstruction or amalgamation.

(v) Compensation payable under the Workmen's Compensation Act, 1923 in respect of the death or disablement of any officer or employee of the company.

(vi) All sums due to any employee from the Provident Fund, Pension Fund, Gratuity Fund or any fund for the welfare of the employee including any contribution due to the fund, and

(vii) Any expenses of investigation held in pursuance of Section 235 and 237 and appointed as payable by the company.

Illustration 9

A company went into liquidation whose creditors are ₹ 36,000 includes ₹ 6,000 on account of wages of 15 men at ₹ 100 per month for 4 months immediately before the date of winding up; ₹ 9,000 being the salaries of 5 employees at ₹ 300 per month for the previous 6 months; Rent for godown for the last six months amounting to ₹ 3,000; Income-tax deducted out of salaries of employees ₹ 1,000 and Directors fee ₹ 500, in addition it is estimated that the company would have to pay ₹ 5,000 as compensation to an employee for injuries suffered by him, which was contingent liability not accepted by the company and not included in the above said creditors figure.

Find the amount of Preferential Creditors.

Solution **Calculation of Preferential Creditors**

Particulars	₹
Tax deducted at source on salaries	1,000
Wages (15 men for 4 months @ ₹ 100 each)	6,000
Salaries (5 employees for 4 months @ ₹ 300 each — Note 1)	6,000
Workmen compensation	5,000
TOTAL	18,000

Tutorial Notes :

(1) The wages or salary for four months must be due within 12 months next preceding to relevant date. The amount shall not exceed ₹ 20,000 for every claimant.

(2) Directors' fees, rent for godown are not included in preferential creditors.

Debentures Having Floating Charge on Assets

After paying off preferential creditors, Debentures having floating charges are paid.

Unsecured Creditors

Unsecured creditors are paid at last.

The debts mentioned above rank equally among themselves and must be paid in full if there are sufficient assets.

Relevant Date

The relevant date means in case of compulsory winding up, the date of appointment of provisional liquidator and if no such appointment has been made the date of winding up order. If the company was in voluntary winding up, then the date of passing of resolution of voluntary winding up.

Contingent Liability

A contingent liability may become an actual liability on the happening of a certain event. In that case, its amount should be included in the category of ***unsecured creditors***.

Interest on Loan, Debentures, etc.

Where the company is ***solvent***, (i.e., the company has ***surplus*** after paying principal and interest up to the date of liquidation) the interest is payable up to the ***date of actual payment***.

Where the company is ***insolvent***, the interest is payable up to the ***date of liquidation***.

Arrear Dividend on Preference Shares

In case of liquidation, arrear dividend on preference shares cannot be paid unless ***declared before the commencement of winding up***. However, it can be paid before anything is paid to equity shareholders by virtue of the terms of issue or provision in the articles of association as a special right.

If the preference dividend has not been declared before the commencement of winding up, it can be paid only after return of equity share capital.

Liquidator's Statement of Account

The liquidator must present to the Court (in case of a compulsory liquidation or liquidation under the supervision of the Court) or with Registrar (in case of a voluntary liquidation) an account of his receipts and payments at least twice a year as long as he is in the office.

The account should be in prescribed form. It should be submitted in duplicate and must be verified by the liquidator. The winding up Court shall cause the account of the liquidator to be audited in such a manner as it thinks fit. One copy of the audited account shall be filed in Court and another copy is to be filed with Registrar of Companies. A printed copy of the audited accounts is to be sent by the liquidator to each creditor and contributory of the company if funds permit.

FORM No. 156

(See Rule 329)

*Here state whether the winding up is a members' or creditors' voluntary winding up or a winding up under the supervision of the Court. If under the supervision of the Court, mention the number of the petition in which the order was made and the date of the order.

Liquidator's Statement of Account of the Winding up (Members' / Creditors'# voluntary winding up)

(Pursuant to section 497/509)*

1. Name of the company . . . .
2. Nature of proceeding* :
3. Date of commencement of the winding-up :
4. Name and address of the Liquidator :

Statement showing how the winding-up has been conducted and the property of the company has been disposed of
From . . . 20. . . (commencement of winding-up) to . . . 20 . . . (close of winding-up)

Receipts	Estimated value	Value realised	Payments		Payments
	₹	₹		₹	₹
Assets			Legal Charges		
Cash at Bank			Liquidator's Remunerations :		
Cash in Hand			Where applicable —		
Marketable securities			. . .% on ₹ . . . realised		
Bills Receivable			. . . % on ₹ . . . distributed		
Trade Debtors			Total		
Loans and Advances			(By whom fixed . . .)		
Stock in Trade			Auctioneers and valuers charges		
Work in Progress			Costs of possession & maintenance of estate		
Freehold Property			Costs of notices in Gazette and newspapers		
Leasehold Property			Incidental outlay (establishment charges and		
Plant and Machinery			other expenses of liquidation		
Furniture, Fittings, Utensils, etc.			Total costs and charges		
Patents, Trade Marks, etc.			(i) Debentureholders :		
Investments other than Marketable			Payment of ₹ . . . per debenture ₹ . . .		
securities			Payment of ₹ . . . per debenture ₹ . . .		
Surplus from Securities			Payment of ₹ . . . per debenture ₹ . . .		
Unpaid Calls at commencement of			(ii) Creditors :		
winding-up			#Preferential		
Amounts received from calls on			#Unsecured		
contributories made in winding-up			Dividend(s) of . . . P. in the rupee on ₹		
Receipts per Trading Account			(The estimate of the amount expected to		

Other Property, viz.,			rank for dividend was ₹ . . .)		
. . .			(iii) Returns to contributories :		
. . .			. . . P. per rupee . . .*share		
Total			. . . P. per rupee . . .*share		
Less:			. . . P. per rupee . . .*share		
Payments to redeem securities					
Costs of execution					
Payments per Trading Account			Add balance		
Net Realisations					

\# State the number. Preferential creditors need not be separately shown if all creditors have been paid in full.

* State nominal value and class of share.

(1) The following assets estimated to be of the value of ₹ . . . have proved to be unrealisable :
(Give details of the assets which have proved to be unrealisable)

(2) Amount paid into the Companies Liquidation Account in respect of :

(a) Unclaimed dividends payable to creditors in the winding up ₹ . . .

(b) Other unclaimed distributions in the winding up ₹ . . .

(c) Moneys held by the company in trust in respect of dividends or other sums due before the commencement of the winding up to any person as a member of the company ₹ . . .

(3) Add here any remarks the liquidator thinks desirable —

Dated this . . . day of . . . 20. . .

Sd/-
Liquidator

I declare that the above statement is true and contains a full and accurate account of the winding up from the commencement to the close of the winding up.

Dated this . . . day of . . . 20. . .

Sd/-
Liquidator

FORM No. 142-B

(See Rule 286)

Central Cash Book

(Cash Book of the Official Liquidator)

Receipts						Payments						
Date	Name of company	Parti-culars	Number of receipt	Amount		Date	Name of company	Parti-culars	Number of voucher or challan	Amount		Number of cheque
				Cash ₹	Bank ₹					Cash ₹	Bank ₹	
1	2	3	4	5	6	7	8	9	10	11	12	13

Instructions :

1. This Register is common to all the liquidations administered by the Official Liquidator, and the day-to-day transactions of the Official Liquidator should be entered in this Register chronologically. Sufficient details should be entered under the column 'particulars' to show clearly the nature of the transaction, the person by whom or to whom the payment was made, and on what account it was made.
2. All cash and cheques received by the Official Liquidator should, upon their receipt, be entered on the Receipts side under 'Cash' and 'Bank' respectively. When the cash collections are paid into the Bank by the Official Liquidator, an entry against cash on the Payments side should be made and a corresponding entry made under Bank on the Receipts side. Where money is withdrawn from the Bank by cheque, the amount should be entered as a payment under 'Bank' on the Payments side and entered as a receipt under 'Cash' on the Receipts side.
3. Where a cheque paid into the Bank is returned dishonoured, the entries previously made in the account in regard to it should be reversed by appropriate reverse entries.
4. Cash and cheques should be remitted into Bank under separate challans, and remittances in respect of each company should be made under a separate challan.
5. Vouchers for payments made by the Official Liquidator should be obtained at the time of making payments, and they should be numbered consecutively in a separate series for each half year. Receipts for payments made to the Official Liquidator should be issued out of a counterfoil receipt book, the leaves of which are machine numbered consecutively.
6. Where the Liquidator carries on a business, only the weekly totals of the Receipts and Payments on the trading account should be brought into the Central Cash Book and the Company's Cash Book from the books of trading accounts.
7. Where dividends are paid to creditors, only the total amounts of the dividends paid each day must be entered in the Central Cash Book and the Company's Cash Book and the details of individual payments made should be entered in the Dividends Paid Register.

8. Cash Books should have their pages machine numbered. As far as possible, no lines should be left blank, but if any space on a page of the Cash Book has to be left blank, a diagonal line should be drawn to cancel the blank space, so that it may not be possible to make any subsequent entries therein. Interpolation of entries should be avoided, but when it becomes necessary to make any entries between two ruled lines or to make any addition to, or interpolation between, entries already made, addition or interpolation should invariably be attested and dated by the Liquidator under his initials.
9. The Cash Book should be balanced at the end of each day and the Cash and Bank Balances carried over to the following day. The Cash on hand should be verified daily by some responsible officer, and at least once a month by the Official Liquidator personally. A certificate of verification of Cash by actual count should be recorded in the Cash Book by the officer verifying the Cash. The Cash Book should be closed monthly under the personal attestation of the Official Liquidator. The Bank balances should be reconciled with the Bank Statement at the end of each month, after taking into account factors arising out of cheques drawn but not cashed, remittances made but adjusted in the Bank's Books under the accounts of a different month.
10. The total of the Cash and Bank Balances of all the companies should be tallied with the balances in the Central Cash Book once every month and a certificate should be recorded in the Register that the total of the balances in the individual companies' accounts agrees with the consolidated balance in the Central Cash Book.

FORM No. 142-C
(See Rule 286)
Company's Cash Book
Company Petition No. . . . of 20 . . .
Name of Company . . . (in liquidation)

			Receipts				Payments				Balance		
Date	Particulars	L.F.	Receipt No.	Cash	Bank	Total	V. No.	Cash	Bank	Total	Cash	Bank	Total
1	2	3	4	5	6	7	8	9	10	11	12	13	14

Instructions :
1. There should be a separate Cash Book for each company.
2. The entries in the Cash Book should be posted from the receipts and vouchers relating to the company and checked with the corresponding entries in the Central Cash Book.
3. Under 'particulars', the head of account to which the entry relates should be indicated so that the entry may be posted under the proper head in the General Ledger.
4. The instructions regarding the filling up of Bank and Cash columns in the Central Cash Book apply in the case of this Cash Book also.
5. The total of the Cash and Bank balances of all the companies should be tallied with the balances in the Central Cash Book once every month.

Liquidator's Remuneration

In case of voluntary winding up, the company in general meeting fix the remuneration of the liquidator or liquidators. In this case, the liqudator earns the remuneration for himself. In case of compulsory liquidation, the Court fixes the remuneration of the liquidator and it is payable to the Court. It is not the personal income of the liquidator. Any remuneration so fixed cannot be increased in any circumstances whatever, whether with or without the sanction of the Court.

The remuneration is usually payable as a percentage on ***collection*** and a percentage on ***distribution.*** Sometimes ***fixed*** amount may be paid as remuneration.

In this respect, the following points are important :

(1) Collection will ***exclude*** cash in hand and cash at bank, i.e., no commission is payable on opening cash and bank balance.

(2) Commission is generally payable for realisation of securities on behalf of secured creditors. The terms of appointment, however, will be the deciding factor. For examination purposes, in the absence of clear and specific direction students should write their assumptions clearly.

(3) **Distribution** includes distribution to creditors and contributories. Commission may be paid for distribution to creditors as well as contributories. Here, again, the terms of appointment will be the deciding factors. For examination purpose, in the absence of clear and specific direction student should write their assumptions clearly.

(4) If the commission is based on ***distribution***, for calculating commission, the following formula should be adopted: $\text{Commission} = \dfrac{P}{100 + P}$

where P = % of commission.

Illustration 10

A liquidator is entitled to receive remuneration @ 2% of the assets realised and 3% of the amount distributed among the unsecured creditors.

The assets realised ₹ 25,00,000 against which payment was made as follows:

	₹
Liquidation expenses	25,000
Preferential creditors	75,000
Secured creditors	10,00,000

Calculate the remuneration payable to the liquidator. ***[C.S. (Inter) — Adapted]***

Solution **Total Commission Payable to Liquidator**

Particulars	₹
(i) Commission on collection (2% of ₹ 25,00,000)	50,000
(ii) Commission on distribution to preferential creditors	2,250
(iii) Commission on distribution to other unsecured creditors (Note 1)	39,255
	91,505

Tutorial Note : Preferential creditors will be treated as unsecured creditors unless it is mentioned specifically.

Working Note : **(1) Commission Payable on Payment to Unsecured Creditors**

Particulars		₹
Total amount realised	₹	25,00,000
Less: Paid to secured creditors	10,00,000	
Liquidation expenses paid	25,000	
Payment to preferential creditors	75,000	
Liquidator's commission on collection of assets (2% of ₹ 25,00,000)	50,000	
Liquidator's commission on payment to preferential creditors (3% of ₹ 75,000)	2,250	11,52,250
Amount payable to unsecured creditors before liquidator's commission		13,47,750

Liquidator's commission = $\frac{3}{103}$ × ₹ 13,47,750 = ₹ 39,255.

Illustration 11

LT Ltd. went into liquidation with the following liabilities:

Secured creditors ₹ 40,000 (securities realised ₹ 50,000); Preferential creditors ₹ 1,200; Unsecured creditors ₹ 61,000; Liquidation expenses ₹ 500.

The liquidator is entitled to a remuneration of 3% on the amount realised (including securities in the hands of secured creditors) and $1^1/_2$% on the amount distributed to unsecured creditors. The various assets (excluding the securities in hands of the secured creditors) realised are ₹ 52,000.

Prepare the Liquidator's Statement of Account showing the payment made to the unsecured creditors.

Solution **LT Ltd. (In liquidation)**
Liquidator's Statement of Account for the period . . .

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Assets Realised		52,000	Liquidation Expenses		500
Surplus from Securities		10,000	Liquidator's Remuneration (Note 1)		3,906
			Creditors :		
			Preferential	1,200	
			Unsecured	56,394	57,594
		62,000			62,000

Tutorial Note : It has been assumed that no commission is payable for payment to preferential creditors. If commission is payable for payment to preferential creditors then total commission will be ₹ (3,060 + 18 + 846) = ₹ **3,924** and amount paid to unsecured creditors = ₹ 56,376.

Working Notes : **(1) Liquidator's Remuneration**

Particulars	₹
3% on assets realised [3% of ₹ (52,000 + 50,000)]	3,060
1.5% on amount distributed to unsecured creditors ($\frac{1.5}{101.5}$ × ₹ 57,240)	846
	3,906

(2) Amount Paid to Unsecured Creditors

₹ 62,000 – 500 – 1,200 – 3,060 = ₹ 57,240 – 846 = ₹ **56,394**.

(3) No remuneration was paid for amount paid to preferential creditors.

Illustration 12

The summarised Balance Sheet of Full Stop Limited as on 31st March, 2017, being the date of voluntary winding up is as under :

Liabilities	₹	Assets	₹
Share Capital :		Land and Building	5,20,000
5,000, 10% Cumulative Preference Shares of ₹ 100 each fully paid up	5,00,000	Plant and Machinery	7,80,000
Equity Share Capital :		Stock-in-trade	3,25,000
5,000 Equity Shares of ₹ 100 each, ₹ 60 per share called up and paid up	3,00,000	Book Debts	10,25,000
5,000 Equity Shares of ₹ 100 each, ₹ 50 per share called up and paid up	2,50,000	Profit and Loss Account	5,50,000
Securities Premium	7,50,000		
10% Debentures	2,10,000		
Preferential Creditors	1,05,000		
Bank Overdraft	4,85,000		
Trade Creditors	6,00,000		
	32,00,000		32,00,000

Preference dividend is in arrears for three years. By 31.3.2017, the assets realised were as follows :

Land and Building — ₹ 6,20,000; Stock-in-trade — ₹ 3,10,000; Plant and Machinery — ₹ 7,10,000; and Book Debts — ₹ 6,60,000.

Expenses of liquidation are ₹ 86,000. The remuneration of the liquidator is 2% of the realisation of assets. Income tax payable on liquidation is ₹ 67,000. Assuming that the final payments wree made on 31-3-2017 prepare the Liquidator's Statement of Account.

Solution

Full Stop Limited (In liquidation)
Liquidator's Statement of Account for the period . . .

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Assets Realised			Liquidation Expenses		86,000
Land and Building		6,20,000	Liquidator's Remuneration (Note 1)		46,000
Stock-in-Trade		3,10,000	**Debentureholders** :		
Plant and Machinery		7,10,000	Principal		2,10,000
Book Debts		6,60,000	**Creditors** :		
			Preferential	1,05,000	
			Income-tax	67,000	
			Bank Overdrafts	4,85,000	
			Trade Creditors	6,00,000	12,57,000
			Return to Contributories :		
			Preference Shareholders —		
			Capital	5,00,000	
			Arrears of Dividend	1,50,000	6,50,000
			Equity Shareholders (Note 2) @ ₹ 10.10 on 5,000 shares of ₹ 60 paid-up	50,500	
			@ ₹ 0.10 on 5,000 shares of ₹ 50 paid-up	500	51,000
		23,00,000			23,00,000

Working Notes :

(1) Liquidator's remuneration is payable @ 2% of the realisation of assets. Therefore, remuneration = 2% of ₹ 23,00,000 = ₹ 46,000.

(2) Amount Payable to Equity Shareholders

Particulars		₹
Balance available after payment to Preference Shareholders [₹ 23,00,000 – 86,000 – 46,000 – 2,10,000 – 12,57,000 – 6,50,000]		51,000
Add: Notional calls :		
5,000 x ₹ 40	2,00,000	
5,000 x ₹ 50	2,50,000	4,50,000

Amount Available	5,01,000
Refund to each Shareholder — ₹ 5,01,000 ÷ 10,000	50.10
(i) Amount payable on ₹ 60 called shares (50.10 – 40.00)	10.10
(ii) Amount payable on ₹ 50 called shares (50.10 – 50.00)	0.10

Illustration 13

From the following Trial Balance of PQ Ltd on 31.12.2016, prepare Liquidator's Final Statement of Account:

Particulars	₹	₹
9% Preference Share Capital (1,250 Preference Shares @ ₹ 100 each fully paid-up)	—	1,25,000
Equity Share Capital :		
2,000 Equity Shares @ ₹ 100 each fully paid-up	—	2,00,000
2,000 Equity Shares @ ₹ 100 each, ₹ 50 paid-up	—	1,00,000
Plant	3,00,000	—
Stock-in-trade	3,60,000	—
Sundry Debtors	85,000	—
Sundry Creditors	—	2,21,000
Bank Balance	1,20,000	—
Preliminary Expenses	6,000	—
6% Mortgage Loan	—	2,30,000
Outstanding Liabilities for Expenses	—	25,000
Profit and Loss Account (Trading Loss for the year 2016)	30,000	—
	9,01,000	9,01,000

Following points should be kept in mind :

(i) On 21st January, 2017 the liquidator of PQ Ltd sold plant for ₹ 2,95,000 and stock in trade at 10% less than the book value. He realised 80% of Sundry Debtors and incurred cost of collection ₹ 1,850 (remaining debtors are to be treated as bad).

(ii) The loan mortgage was discharged on 31st January, 2017 along with interest for 6 months. Creditors were discharged subject to 5% discount. Outstanding expenses paid at 20% less.

(iii) Preference share dividend is due for one year and paid with final payment.

(iv) Liquidation expenses incurred are ₹ 1,800 and liquidators remuneration is settled at 4% on disbursement to members (excluding preference dividend), subject to minimum of ₹ 10,000.

Solution

PQ Ltd (In liquidation)
Liquidator's Statement of Account for the period . . .

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Bank		1,20,000	Liquidation Expenses		1,800
Assets Realised			Liquidator's Remuneration (Note 1)		12,510
Plant		2,95,000	**6% Mortgage Loan** :		
Stock		3,24,000	Principal	2,30,000	
Debtors (₹ 68,000 – ₹ 1,850)		66,150	Interest for 6 months	6,900	2,36,900
			Creditors :		
			Unsecured	2,09,950	
			Outstanding liability for expenses	20,000	2,29,950
			Return to Contributories :		
			Preference Shareholders —		
			Capital	1,25,000	
			Arrears of Dividend	11,250	1,36,250
			Equity Shareholders —		
			@ ₹ 71.935 on 2,000 fully paid shares		1,43,870
			@ ₹ 21.935 on 2,000 ₹ 50 paid shares (Note 2)		43,870
		8,05,150			8,05,150

Working Notes :

(1) Liquidator's Remuneration

Particulars	₹
Available Surplus for members*	3,25,250
Less: Liquidator's remuneration [(₹ 3,25,250 x 4) ÷ 104]	12,510
Amount to be paid to Members	3,12,740

* **Available Surplus** : ₹ 8,05,150 – 1,800 – 2,36,900 – 20,000 – 2,09,950 – 11,250 = ₹ **3,25,250**.

(2) Amount to be Paid to Equity Shareholders

Particulars	₹
Amount available for members	3,12,740
Less : Preference Share Capital	1,25,000
Amount available for payment to Equity Shareholders	1,87,740
Amount available after payment to Preference Shareholders	1,87,740
Add: Notional payment by equity shareholders @ ₹ 50 on 2,000 shares	1,00,000
Amount available	2,87,740
Refund to each shareholder — ₹ 2,87,740 ÷ 4,000	71.935
(i) Amount payable per fully paid-up share	71.935
(ii) Amount payable per ₹ 50 paid-up share (₹ 71.935 – 50)	21.935

Illustration 14

Balance Sheet of Sona Limited as on 31st December, 2015

Liabilities	₹	Assets	₹
Paid-up Capital —		Fixed Assets —	
1,000, 6% Preference Shares of ₹ 100 each	1,00,000	Land and Building	2,00,000
2,000 Equity Shares of ₹ 100 each fully paid	2,00,000	Plant and Machinery	2,20,000
3,000 Equity Shares of ₹ 100 each, ₹ 50 paid	1,50,000	Current Assets —	
Secured Loan —		Stock	1,00,000
6% Debentures (Floating Charge on all Assets)	1,00,000	Debtors	1,00,000
Others —		Cash at Bank	30,000
Mortgage on Land and Building	1,00,000	Miscellaneous Expenditure —	
Current Liabilities —		Profit and Loss Account	1,00,000
Sundry Creditors	90,000		
Income-tax	10,000		
	7,50,000		7,50,000

The Company went into liquidation on 1st January, 2016.

The preference dividends were in arrear for three years. The arrears are payable on liquidation.

The assets were realised as follows:

	₹
Land and Building	2,40,000
Plant and Machinery	1,80,000
Stock	70,000
Debtors	60,000

The expenses of liquidation amounted to ₹ 8,000.

The liquidator is entitled to a commission at 2% on all assets realised and 3% on amounts distributed to unsecured creditors.

All payments were made on 30th June, 2016.

Prepare Liquidator's Statement of Account.

Solution

Sona Ltd. (In liquidation)

Liquidator's Statement of Account for the period 1st January to 30th June, 2016

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Cash at Bank		30,000	Liquidation Expenses		8,000
Assets Realised			Liquidator's Remuneration (Note 1)		14,000
Sundry Debtors		60,000	**Debentureholders** :		
Stock-in-Trade		70,000	Principal	1,00,000	
Plant and Machinery		1,80,000	Interest upto 30.6.2016 (Note 2)	3,000	1,03,000
Surplus from Securities		1,40,000	**Creditors** :		
			Preferential	10,000	
			Unsecured	90,000	1,00,000
			Return to Contributories :		
			Preference Shareholders —		
			Capital	1,00,000	
			Arrears of Dividend (Note 3)	18,000	1,18,000
			Equity Shareholders (Note 4)		
			@ ₹ 57.40 on 20,000 shares	1,14,800	
			@ ₹ 7.40 on 3,000 shares	22,200	1,37,000
		4,80,000			4,80,000

Working Notes : **(1) Liquidator's Remuneration**

Particulars	₹
2% on ₹ 5,50,000 realised	11,000
3% on ₹ 1,00,000 distributed among unsecured creditors	3,000
	14,000
(2) Debentureholders are entitled to interest upto the date of payment since the company is solvent.	
(3) Preference dividend is payable up to 31.12.20125	

(4) Amount Payable to Equity Shareholders

Particulars	₹
Balance available after payment to preference shareholders	1,37,000
Add: Notional payment by equity shareholders @ ₹ 50 on 3,000 shares	1,50,000
Amount available	2,87,000
Refund to each shareholder ₹ 2,87,000 ÷ 5,000	57.40
Amount payable for fully paid-up shares	57.40
Amount payable for partly paid-up shares (₹ 57.40 – ₹ 50.00)	7.40

Illustration 15

Prakash Processors Ltd. went into voluntary liquidation on 31st December, 2016 when their Balance Sheet read as follows:

Liabilities	₹	Assets	₹
Issued and Subscribed Capital :		Land and Buildings	2,50,000
5,000, 10% cumulative preference shares of ₹ 100		Machinery and Plant	6,25,000
each fully paid	5,00,000	Patents	1,00,000
2,500 equity shares of ₹ 100 each, ₹ 75 paid	1,87,500	Stock	1,37,500
7,500 equity shares of ₹ 100 each, ₹ 60 paid	4,50,000	Sundry Debtors	2,75,000
15% Debentures secured by a floating charge	2,50,000	Cash at Bank	75,000
Interest outstanding on Debentures	37,500	Profit and Loss Account	2,81,250
Creditors	3,18,750		
	17,43,750		17,43,750

Preference dividends were in arrears for 2 years and the creditors included preferential creditors of ₹ 38,000. The assets realised as follows : Land and buildings ₹ 3,00,000; Machinery and plant ₹ 5,00,000; Patents ₹ 75,000; Stock ₹ 1,50,000; Sundry debtors ₹ 2,00,000.

The expenses of liquidation amounted to ₹ 27,250. The liquidator is entitled to a commission of 3% on assets realised except cash. Assuming the final payments including those on debentures is made on 30th June, 2017, show the Liquidator's Final Statement of Account.

Solution **Prakash Processors Limited (In liquidation)**

Liquidator's Final Statement of Accounts for the period 1st January to 30th June, 2017

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Bank		75,000	Liquidation Expenses		27,250
Assets Realised			Liquidator's Remuneration (Note 1)		36,750
Land and Building		3,00,000	**Debentureholders** :		
Machinery and Plant		5,00,000	Principal	2,50,000	
Patents		75,000	Interest Accrued	37,500	
Stock		1,50,000	Interest upto 30.6.2017 (Note 2)	18,750	3,06,250
Sundry Debtors		2,00,000	**Creditors** :		
Collection from Contributories			Preferential	38,000	
@ ₹ 2.65 on 7,500 equity shares			Unsecured	2,80,750	3,18,750
on which ₹ 60 paid up (Note 3)		19,875			
			Return to Contributories :		
			Preference Shareholders —		
			Capital	5,00,000	
			Arrears of Dividend	1,00,000	6,00,000
			Equity Shareholders (Note 4) @ ₹ 12.35 on 2,500 shares on which ₹ 75 was paid up		30,875
		13,19,875			13,19,875

Working Notes :

(1) Liquidator's Remuneration @ 3% on amount realised = ₹ 12,25,000 × 3/100 = ₹ 36,750.

(2) Debentureholders are entitled to interest up to the date of payment since the company is solvent. Interest for 1.1.2017 to 30.6.2017 = ₹ 2,50,000 × $\frac{15}{100} \times \frac{1}{2}$ = ₹ **18,750**.

(3) Preference dividend is payable up to 31.12.2016, as it is cumulative preference shares.

(4) Collection from Contributories / Payment to Contributories

Particulars	₹
Total equity capital paid up (₹ 1,87,500 + 4,50,000)	6,37,500
Less: Balance available to equity shareholders after payment to creditors and preference shareholders (Note 5)	11,000
Loss to be borne by 10,000 equity shareholders	6,26,500
Loss per share ₹ 6,26,500 ÷ 10,000	62.65

Amount of call on ₹ 60 paid shares (₹ 62.65 – ₹ 60.00) = ₹ 2.65.

Total amount collected = 7,500 × ₹ 2.65 = ₹ **19,875**.

Total amount to be refunded = 2,500 × (₹ 75 – ₹ 62.65) = ₹ **30,875**.

(5) Amount available for payment

	₹	
(₹ 75,000 + 3,00,000 + 5,00,000 + 75,000 + 1,50,000 + 2,00,000)	13,00,000	
Amount paid (₹ 27,250 + 36,750 + 3,06,250 + 3,18,750 + 6,00,000)	12,89,000	
		11,000

Calls-in-Arrear and Calls-in-Advance

Before making payment to the contributories if there is any calls-in-arrear, it should be collected by the liquidator first. Similarly, if there is any calls-in-advance, it should be returned to the concerned shareholders before making any payment for capital.

Illustration 16

The position of Valueless Ltd on its liquidation is as under :

Issued and paid-up Capital

3,000, 11% preference shares of ₹ 100 each fully paid.

3,000 Equity shares of ₹ 100 each fully paid.

1,000 Equity shares of ₹ 50 each, ₹ 30 each per share paid.

Calls-in-Arrears are ₹ 10,000 and Calls received in Advance ₹ 5,000. Preference dividends are in arrears for one year. Amount left with the liquidator after discharging all liabilities is ₹ 4,13,000. Articles of Association of the company provide for payment of preference dividend arrears in priority to return of equity capital. You are required to prepare the Liquidator's Final Statement of Account.

Solution

Valueless Ltd.

Liquidator's Final Statement of Account for the period . . .

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Cash in Hand		4,13,000	**Returned to Contributories** :		
Realisation from :			Preference Sahreholders —		
Calls in arrears		10,000	Capital	3,00,000	
Final call @ ₹ 5 on 1,000 equity shares of ₹ 50 each		5,000	Arrears of Dividend	33,000	3,33,000
			Equity Shareholders —		
			Calls in Advance (Note 2)		5,000
			Capital (Note 1)		90,000
		4,28,000			4,28,000

Working Notes :

(1) Collection from Equity Shareholders / Payment to Equity Shareholders

		₹	₹
Cash in Hand			4,13,000
Add: Calls in Arrears			10,000
			4,23,000
Less:	Payment to Preference Shareholders (₹ 3,00,000 + 33,000)	3,33,000	
	Calls in Advance	5,000	3,38,000
			85,000
Add: Amount to be paid by the equity shareholders of ₹ 50 each (₹ 20 x 1,000)			20,000
Amount available for payment to equity shareholders			1,05,000

Number of Equivalent Equity Shares :

3,000 Shares of ₹ 100 each	6,000 shares of ₹ 50 each
1,000 Shares of ₹ 50 each	1,000 shares of ₹ 50 each
	7,000 shares of ₹ 50 each

$$\text{Final Payment to Equity Shareholders} = \frac{\text{Amount available for Distribution}}{\text{Number of Equivalent Shares}}$$

$$= \frac{85,000}{7,000} = ₹\ 15 \text{ per share of } ₹\ \mathbf{50\ each}.$$

Equity Shareholders of ₹ 100 each will get (Rs $15 \times \frac{100}{50}$) = ₹ **30 each.**

Equity shareholders of ₹ 50 each will get ₹ 15 per share but they have to pay ₹ 20 per share. As a result, they are required to pay net ₹ 5 per share.

(2) Calls-in-advance must be paid first, so as to pay the shareholders on pro-rata basis.

Illustration 17

The following was the Balance Sheet of X Limited as on 31.3.2016 :

Liabilities	₹	Assets	₹
Share Capital :		**Fixed Assets**	
14%, 4,000 pref. shares of ₹ 100 each fully paid up	4,00,000	Land	40,000
8,000 equity shares of ₹ 100 each, ₹ 60 per share paid up	4,80,000	Buildings	1,60,000
		Plant and Machinery	5,40,000
Reserves and Surplus	Nil	Patents	40,000
Secured Loans		**Investments**	Nil
14% debent. (having a floating charge on all assets)	2,30,000	**Current Assets, Loans and Advances**	
Interest accrued on above debentures (also having a floating charge as above)	32,200	*Current Assets*	
		Stock at cost	1,00,000
Loan on mortgage of land and building	1,50,000	Sundry Debtors	2,30,000
Unsecured Loan	Nil	Cash at Bank	60,000
Current Liabilities and Provisions		*Loans and Advances*	Nil
Current Liabilities		Miscellaneous Expenses	
Sundry Creditors	1,17,800	Profit and Loss Account	2,40,000
	14,10,000		14,10,000

On 31.3.2016, the company went into voluntary liquidation. The dividend on 14% preference shares was in arrears for one year. Sundry creditors include preferential creditors amounted to ₹ 30,000.

The assets realised the following sums :

Land ₹ 80,000; Buildings ₹ 2,00,000; Plant and machinery ₹ 5,00,000; Patent ₹ 50,000; Stock ₹ 1,60,000; Sundry debtors ₹ 2,00,000.

The expenses of liquidation amounted to ₹ 29,434. The liquidator is entitled to a commission of 2% on all assets realised (except cash at bank) and 2% on amounts distributed among unsecured creditors other than preferential creditors. All payments were made on 30th June, 2016. Interest on mortgage loan shall be ignored at the time of payment.

Prepare the Liquidator's Final Statement of Account.

Solution

X Limited (In liquidation)

Liquidator's Statement of Account for the period 1st April to 30th June, 2016

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Cash at Bank		60,000	Liquidation Expenses		29,434
Assets Realised			Liquidator's Remuneration (Note 1)		25,556
Sundry Debtors		2,00,000	**Debentureholders** :		
Stock		1,60,000	Principal	2,30,000	
Plant and Machinery		5,00,000	Interest upto 30.6.2016 (Note 2)	40,250	2,70,250
Patents		50,000	**Creditors** :		
Surplus from Securities (Note 3)		1,30,000	Preferential	30,000	
			Unsecured	87,800	1,17,800
			Return to Contributories :		
			Preference Shareholders —		
			Capital	4,00,000	
			Arrears of Dividend	56,000	4,56,000
			Equity Shareholders (Note 3) —		
			@ ₹ 25.12 on 8,000 shares		2,00,960
		11,00,000			11,00,000

Working Notes : **(1) Liquidator's Remuneration**

	₹
2% on assets realised (2% of ₹ 11,90,000)	23,800
2% on payment to unsecured creditors (2% of ₹ 87,800)	1,756
	25,556
(2) Interest Accrued on 14% Debentures	
Interest accrued as on 31.3.2016	32,200
Interest accrued up to the date of payment, i.e., 30.6.2016	8,050
	40,250
(3) Surplus from Securities	
Amount realised from land and building (₹ 80,000 + 2,00,000)	2,80,000
Loss: Mortgage Loan	1,50,000
	1,30,000
(4) Amount Payable to Equity Shareholders	
Equity Share Capital (Paid-up)	4,80,000
Less: Amount available for equity shareholders	2,00,960
Loss to be borne by the Equity Shareholders	2,79,040
Less per equity share (₹ 2,79,040 ÷ 8,000)	34.88
Amount payable to equity shareholder for each ₹ 60 paid-up share (₹ 60 – 34.88)	₹ 25.12
(5) Liquidator's commission has been calculated on total realisation including land and building.	
(6) Preference shares have been taken as cumulative.	

Illustration 18

Bekar Limited went into voluntary liquidation. The details regarding liquidation are as follows:

Share Capital :

1. 2,000, 8% preference shares of ₹ 100 each (fully paid-up).
2. Class A 2,000 equity shares of ₹ 100 each (₹ 75 paid-up).
3. Class B 1,600 equity shares of ₹ 100 each (₹ 60 paid-up).
4. Class C 1,400 equity shares of ₹ 100 each (₹ 50 paid-up).

Assets including machinery realised ₹ 4,20,000. Liquidation expenses amount to ₹ 15,000.

Bekar Limited has borrowed a loan of ₹ 50,000 from Patel Brothers against the mortgage of machinery (which realised ₹ 80,500). In the books of the company, salaries of four clerks for four months at a rate of ₹ 300 per month and salaries of four persons for three months at a rate of ₹ 150 per month are outstanding. In addition to this, the company's books show creditors worth ₹ 87,400.

Prepare Liquidator's Statement of Account.

Solution

Bekar Limited (In liquidation)
Liquidator's Statement of Accounts for the period . . .

Receipts	Estimated value ₹	Valued Realised ₹	Payments	₹	₹
Assets Realised		3,39,500	Liquidation Expenses		15,000
Surplus from Secured Creditors			**Creditors** :		
[₹ 80,500 – 50,000)		30,500	Preferential (Note 1)	6,600	
Call @ Re 1 on 1,400 Class 'C' shares		1,624	Unsecured	88,200	94,800
			Return to Contributories:		
			Preference Shareholders		2,00,000
			Class 'A' equity shareholders		47,780
			Class 'B' equity shareholders		14,144
		3,71,624			3,71,624

Working Notes :

(1) Preferential Creditors :

	₹	₹
(i) Salaries of 4 clerks @ ₹ 300 p.m. for 4 months	4,800	
(ii) Salaries of 4 persons @ ₹ 150 p.m. for 3 months	1,800	6,600

Tutorial Note :

At present, for the purpose of preferential creditors, maximum limit is ₹ 20,000 for only one claimant. However, previously it was ₹ 1,000 per claimant.

(2) Collection from Contributories / Payment to Contributories

Particulars		₹
Total equity capital paid-up :	₹	
Class A : 2,000 x ₹ 75	1,50,000	
Class B : 1,600 x ₹ 60	96,000	
Class C : 1,400 x ₹ 50	70,000	3,16,000
Less: Balance available to equity shareholders after paid to creditors and preferential shareholders (Note 2)		60,200
Loss to be borne by the equity shareholders		2,55,800
Loss per equity shares = $\frac{2,55,800}{5,000}$		51.16

Particulars		Class 'A'	Class 'B'	Class 'C
Paid-up Amount	₹	75.00	60.00	50.00
Loss per Share	₹	51.16	51.16	51.16
Refund / Call	₹	23.84 (Refund)	8.84 (Refund)	1.16 (Call)
Total	₹	47,680	14,144	1,624

(3) Surplus Available to Equity Shareholders

	₹	₹
Receipts :		
Assets Realised	3,39,500	
Surplus from Secured Creditors	30,500	3,70,000
Less: **Payments** :		
Liquidation Expenses	15,000	
Preferential Creditors	6,600	
Unsecured Creditors	88,200	
Preference Shareholders	2,00,000	3,09,800
Surplus		60,200

KEY POINTS

- Winding up or liquidation is the process by which the management of a company's affairs is taken out of its directors' hands. Its directors usually become defunct.
- A compulsory winding up takes place when a company is directed to be wound up by an order of Court.
- Voluntary winding up means winding up by the members themselves without the intervention of the Court.
- ***There are two types of voluntary winding up*** : Members' Voluntary Winding Up; and Creditors' Voluntary Winding Up.
- If the company is, at the time of winding up, a solvent company and the directors make a declaration to that effect, it is called a *Members' Voluntary Winding Up'*. If the company is not in a position to pay its debts and the directors make no declaration of solvency, it is called a *'Creditors' Voluntary Winding Up'*.
- Upon the death of a contributory, his legal representative becomes a contributory — Section 430. In case of insolvency, the contribution due can be proved as a debt in the insolvency proceedings — Section 431.

ITHEORETICAL QUESTIONS

1. (a) What do you mean by liquidation of a company ?
   (b) What are the different ways in which a company may be wound up ?
2. What is a statement of affairs ? When it is prepared ? Give a specimen form of this statement and explain it.
3. Under what circumstances can the Court order that a company be compulsorily wound up ? Who can file petition for compulsory winding up ?
4. Who is a contributor ? Discuss his liability.
5. What do you understand by Liquidator's Statement of Account? When it is prepared and how ?
6. What do you mean by Members' voluntary winding up ? How does it differ from Creditors' voluntary winding up?
7. What do you mean by preferential creditors ? Outline the order of preferential payments when a company is under liquidation ?
8. When is winding up deemed to commence in the case of voluntary winding up and compulsory winding up ?

PRACTICAL QUESTIONS

Preparation of Statement of Affairs

1. M Co Ltd went into voluntary liquidation on 1st March, 2016. The following balances are extracted from its books on that date :

Liabilities	₹	Assets		₹
Capital :		Buildings		1,50,000
50,000 equity shares of ₹ 10 each	5,00,000	Plant and Machinery		2,10,000
Debentures (secured by floating charge)	2,00,000	Stock-in-Trade		95,000
Bank Overdraft	30,000	Book Debts	75,000	
Creditors	40,000	Less: Provision	10,000	65,000
		Calls-in-Arrear		1,00,000
		Cash in Hand		10,000
		Profit and Loss Account		1,40,000
	7,70,000			7,70,000

Plant and machinery and buildings are valued at ₹ 1,50,000 and ₹ 1,20,000 respective ly. On realisation, losses of ₹ 15,000 are expected on stock. Book debts will realise ₹ 70,000. Calls-in-arrears are expected to realise 90%. Bank overdraft is secured against buildings. Preferential creditors for taxes and wages are ₹ 6,000 and miscellaneous expenses outstanding ₹ 2,000.

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

2. Shri Chopra is appointed liquidator of Moon Company Limited, in voluntary liquidation, on 1 July 2016. Following balances are extracted from the books on that date :

Liabilities	₹	Assets	₹
Capital :		Machinery	45,000
24,000 shares of ₹ 5 each	1,20,000	Leasehold Properties	60,000
Provision for bad debts	15,000	Stock-in-trade	1,500
Debentures	75,000	Book Debts	90,000
Bank Overdraft	27,000	Investments	9,000
Liabilities for Purchases	30,000	Calls-in-Arrear	7,500
		Cash in Hand	1,500
		Profit and Loss Account	52,500
	2,67,000		2,67,000

You are required to prepare a Statement of Affairs and Deficiency / Surplus Account to be submitted to the meeting of the creditors. The following assets are valued as under :

Machinery — ₹ 90,000; Leasehold properties — ₹ 1,09,000; Investments — ₹ 6,000; and Stock-in-trade — ₹ 3,000.

Bad Debts are ₹ 3,000 and the doubtful debts are ₹ 6,000 which are estimated to realise ₹ 3,000. The bank overdraft is secured by deposit of title deeds of leasehold properties. Preferential creditors are ₹ 1,500. Telephone rent outstanding ₹ 120.

3. On January 31, 2016 a compulsory order for winding up was made against X Company Limited, the following particulars being disclosed :

Liabilities	Book value (₹)	Estimated to produce (₹)
Cash in hand	100	100
Debtors	4,000	3,600
Land and Buildings	60,000	48,000
Furniture and Fixtures	20,000	20,000
Unsecured Creditors	20,000	
Debentures :		
Secured on Land and Buildings	42,000	
Secured on Floating Charge	10,000	
Preferential Creditors	6,000	
Share capital (3,200 shares of ₹ 100 each)	3,20,000	

Estimated liability for bills discounted was ₹ 6,000 estimated to rank at ₹ 6,000. Other contingent liabilities were ₹ 12,000 — estimated to rank at ₹ 12,000.

The company was formed on the 1st day of January, 2003 and has made losses of ₹ 31,13,900.

Prepare Statement of Affairs and Deficiency Account.

4. Optimists Ltd. resolved to wind up as on 31.12.2016 as members' voluntary winding up. The Trial balance as on that date was :

Liabilities	Dr. (₹)	Cr. (₹)
Equity Share Capital (₹ 10 each fully paid)		1,50,000
8% Cumulative Preference Shares (₹ 10 each fully paid)		30,000
Plant — Cost	1,60,000	
Depreciation Provision		30,000
Stock on 31.12.2016	66,000	
Sundry Debtors and Creditors	50,000	60,000
Profit and Loss Account		
Balance on 1.1.2016		35,000
Loss in 2016	15,000	
Preference Dividend — Paid for half year upto June 30	1,200	
Preliminary Expenses	4,800	
Bank	8,000	
	3,05,000	3,05,000

On 1.1.2017 the liquidator sold some of the assets to Optimists (2017) Ltd for the following valuations: Plant ₹ 90,000; Goodwill ₹ 25,000; Stock ₹ 40,000.
The purchase consideration was satisfied by 8% Debentures of ₹ 75,000 issued at 4% discount and the balance in cash.
Preference shareholders are to be paid dividend upto the date of commencement of liquidation and 5% premium before anything is paid to equity shareholders.
Debtors realised ₹ 40,000 gross, collection expenses being ₹ 500. Six months' Debenture interest was received from Optimists (2017) Ltd. on 30.6.2017. The creditors were discharged subject to 5% discount. Liquidation expenses amounted to ₹ 800 and liquidator's remuneration was paid ₹ 4,000.
Preference shareholders are paid in cash with premium and dividend. The debentures and cash balance were paid to the equity shareholders. Prepare : (a) Statement of Affairs as on 31.12.2016 on the basis of facts known as on that date and the agreement with Optimists (2017) Ltd.; and (b) Deficiency Account upto 31.12.2016.

Calculation of Liabilities of Contributories

5. Bad Luck Limited went into voluntary liquidation and the proceedings commenced on 2 July, 2016. Certain creditors could not receive payment out of the realisation of assets and out of the contributions from the contributories of the 'A' List. The following details of share transfers are made available to you.

Name of the Transferor Shareholders	Number of Shares Transferred	Date of the Transferor Ceasing to be a Member	Creditors Remaining Unpaid and Outstanding at the Time of the Transferor Ceasing to be a Member
(i) A	1,000	1 March, 2015	6,000
(ii) B	1,250	15 August, 2015	8,000
(iii) C	500	1 October, 2015	10,750
(iv) D	2,000	1 December, 2015	13,000
(v) E	250	1 April, 2016	15,000

All the shares were of ₹ 10 each, on which ₹ 5 per share had been paid-up. Ignoring other details like liquidator's expenses, etc., you are required to work out the liability of the individual contributories listed above.

6. In a winding up which commenced on 15th September, 2016 certain creditors could not receive payments out of the realisation of assets and out of contribution from 'A' list of contributories. Following are the details of certain share transfers that took place prior to liquidation and the amount of creditors remaining unpaid:

Name of the Transferor Shareholders	Number of Shares Transferred	Date of Transferor Ceasing to be a Member	Creditors Remaining Unpaid and Outstanding at the Time of the Transferor Ceasing to be a Member
L	2,000	31.08.2015	8,000
M	1,800	20.09.2015	12,000
N	1,200	15.11.2015	17,400
O	1,000	22.04.2016	18,600
P	500	10.07.2016	22,000

All the shares were of ₹ 10 each, on which ₹ 5 per share had been called and paid-up. Ignoring expenses of liquidation, remuneration to liquidator etc., work out the amount to be realised from the above contributories.

Preparation of Liquidator's Statement of Account

7. The Balance Sheet of Bubble Ltd. as on 31st December, 2016 was as follows:

Liabilities	₹	Assets	₹
Share Capital :		Land and Building	25,000
8,000 Preference Shares of ₹ 10 each	80,000	Other Fixed Assets	2,00,000
1,200 Equity Shares of ₹ 10 each	1,20,000	Stock	5,25,000
Bank Loan	4,00,000	Debtors	1,00,000
6% Debentures	1,00,000	Profit and Loss Account	58,000
Interest Outstanding on Debentures	8,000		
Creditors	2,00,000		
	9,08,000		9,08,000

The company went into liquidation on that date. Prepare Liquidator's Statement of Account after taking into account the following :

(1) Liquidation expenses and liquidator's remuneration amounted to ₹ 3,000 and ₹ 10,000, respectively.
(2) Bank loan was secured by pledge of stock.
(3) Debentures and interest thereon are secured by a floating charge on all assets.
(4) Fixed assets were realised at book values and current assets at 80% of book values.

8. The summarised Balance Sheet of Mathew Limited as on 31.3.2016 being the date of voluntary winding up is as under:

Liabilities	₹	Assets	₹
Share Capital :		Land and Building	3,86,000
12% Cumulative Preference Shares :		Plant and Machinery	8,21,000
10,000 shares of ₹ 100 each fully paid-up	10,00,000	Stock-in-trade	1,84,000
Equity Share Capital :		Book Debts	13,37,000
5,000 equity shares of ₹ 100 each, ₹ 60 per share called and paid-up	3,00,000	Profit and Loss Account	3,72,000
5,000 equity shares of ₹ 100 each, ₹ 50 per share called and paid-up	2,50,000		
Paid-up share capital	15,50,000		
15% Debentures	4,00,000		
Preferential Creditors	1,05,000		
Bank Overdraft	3,03,000		
Trade Creditors	7,42,000		
	31,00,000		31,00,000

Preference dividend is in arrears for two years. By 31.3.2016 the assets were realised as follows :
Land and building — ₹ 9,84,000; Stock-in-trade — ₹ 1,63,000; Plant and machinery — ₹ 7,12,000; and Book debts — ₹ 11,91,000.
Expenses of liquidation is ₹ 54,000. The remuneration of the liquidator is 3 per cent of the realisation. Income tax payable on liquidation is ₹ 44,500. Assuming that the final payments are made on 31.3.2016 prepare the Liquidator's Final Statement of Account.

9. X Ltd. went into voluntary liquidation on 31st December, 2016 when their Balance Sheet read as follows:

Liabilities	₹	Assets	₹
Issued and Subscribed Capital :		Land and Buildings	7,50,000
15,000, 10% cumulative preference shares of ₹ 100 each fully paid	15,00,000	Machinery and Plant	18,75,000
		Patents	3,00,000
7,500 equity shares of ₹ 100 each, ₹ 75 paid	5,62,500	Stock	4,02,500
22,500 equity shares of ₹ 100 each, ₹ 60 paid	13,50,000	Sundry Debtors	8,25,000
15% Debentures secured by a floating charge	7,50,000	Cash at Bank	2,25,000
Interest outstanding on debentures	1,12,500	Profit and Loss Account	8,53,750
Creditors	9,56,250		
	52,31,250		52,31,250

Preference dividends were in arrears for 2 years and the creditors included preferential creditors of ₹ 38,000. The assets were realised as follows:
Land and buildings ₹ 9,00,000; Machinery and plant ₹ 15,00,000; Patents ₹ 2,25,000; Stock ₹ 4,50,000; Sundry Debtors ₹ 6,00,000.
The expenses of liquidation amounted to ₹ 27,250. The liquidator is entitled to a commission of 3% on assets realised except cash. Assuming that final payments including those on debentures were made on 30th June, 2016.
Show the Liquidator's Final Statement of Account.

10. A.G. Ltd. went into liquidation with the following liabilities :
(a) Secured creditors ₹ 20,000 (securities realised ₹ 25,000).
(b) Preferential creditors ₹ 600.
(c) Unrealised creditors ₹ 30,500.
Liquidator's out of pocket expenses amount to ₹ 252. The liquidator is entitled to a remuneration of 3% on the amounts realised and 1.5% on the amount distributed to unsecured creditors. The various assets (excluding securities in the hand of creditors) fully realised ₹ 26,000.
You are required to prepare Liquidator's Statement of Account.
Note : The liquidator is entitled to his remuneration on the realisation of securities in the hands of the secured creditors. No commission is payable for payment to preferential creditors.

11. The Breakfast Foods Ltd. went into voluntary liquidation on 31st December, 2016. The balances in its books on that date were :

Liabilities	₹	Assets	₹
Share Capital :		Land and Buildings	2,50,000
Authorised and Subscribed :		Machinery and Plant	6,25,000
5,000, 6% Cumulative Preference Shares of	5,00,000	Patents	1,00,000
₹ 100 each fully paid		Stock	1,37,500
2,500 Equity Shares of ₹ 100 each, ₹ 75 paid	1,87,500	Sundry Debtors	2,75,000
7,500 Equity Shares of ₹ 100 each, ₹ 60 paid	4,50,000	Cash at Bank	75,000
5% Mortgage Debentures	2,50,000	Profit and Loss Account	3,00,000
Interest Outstanding	12,500		
Creditors	3,62,500		
	17,62,500		17,62,500

The liquidator is entitled to commission of 3% on all assets realised except cash and 2% on amounts distributed among unsecured creditors other than preferential creditors.
Creditors include preferential creditors ₹ 37,500 and a loan for ₹ 1,25,000 secured by a mortgage on land and buildings. The preference dividends were in arrears for two years. The assets realised as follows:

	₹
Land and Buildings	3,00,000
Machinery and Plant	5,00,000
Patents	75,000
Stock	1,50,000
Sundry Debtors	2,00,000

The expenses of liquidation amounted to ₹ 27,250.
Prepare the Liquidator's Final Statement of Account. ***[Delhi University, B.Com. (Hons.) — Adapted]***

12. The capital of Data Company Limited was as follows :
(1) 4,000 equity shares of ₹ 100 each fully paid;
(2) 3,000 equity shares of ₹ 100 each, ₹ 80 per share paid-up;
(3) 1,000 preference shares of ₹ 100 each fully paid (these shares have preference as to capital); and
(4) 1,000 deferred shares of ₹ 100 each, ₹ 80 per share paid-up (these shares, under the articles are to be paid after satisfying the claims of equity shareholders).
The various creditors amounted in all to ₹ 1,00,000 including the liquidator's remuneration of ₹ 2,500. The liquidator made a call of the remaining ₹ 20 on the deferred shares which were paid in full. He also realised all the assets amounting to ₹ 1,91,000.
A call of ₹ 15 per share was made on the equity shares which were partly paid-up. This was paid in full with the exception of that on 100 shares.
Prepare the Liquidator's Account showing the return of money to the shareholders.

13. T Ltd. was placed in voluntary liquidation on 31 December, 2016, when the Balance Sheet was as follows:

Liabilities	₹	Assets	₹
Issued Share Capital :		Freehold Factory	5,80,000
50,000 Equity Shares of ₹ 10 each fully paid less		Plant and Machinery	2,89,000
calls-in-arrears amounting to ₹ 25,000	4,75,000	Motor Vehicles	57,500
6,000, 5% Cumulative Preference Shares of ₹ 100		Stock	1,86,000
each fully paid	6,00,000	Debtors	74,000
Securities Premium A/c	50,000	Profit and Loss Account	2,14,000
5% Debentures A/c	1,00,000		
Interest on Debentures	2,500		

Bank Overdraft	58,000		
Creditors	1,15,000		
	14,00,500		14,00,500

The preference dividends in arrears from 2013 onwards.

The company's article provide that on liquidation, out of the surplus assets remaining after payment of liquidation costs and outside liabilities, there shall be paid firstly all arrears of preference dividend, secondly the amount paid-up on the preference shares together with a premium thereon of ₹ 10 per share, and thirdly any balance then remaining shall be paid to the equity shareholders.

The Bank overdraft was guaranteed by the directors who were called upon by the bank to discharge their liability under the guarantee. The directors paid the amount to the bank.

The liquidator realised the assets as follows :

Freehold factory — ₹ 7,00,000; Plant and machinery — ₹ 2,40,000; Motor vehicles — ₹ 59,000; Stock — ₹ 1,50,000; Debtors — ₹ 60,000; Calls-in-arrears — ₹ 25,000.

Creditors were paid less discount of 5%. The debentures and accrued interest were repaid on 31st March, 2017.

Liquidation cost were ₹ 3,820 and the liquidator's remuneration was 2% on the amount realised.

Prepare a Liquidator's Statement of Account. ***[C.A. (Inter) — Adapted]***

Guide to Answers

Practical Questions

1. **Deficiency as regard contributories ₹ 2,50,000.**
2. **Surplus as regard contributories ₹ 47,380.**
3. **(i) Deficiency as regard creditors ₹ 24,300; (ii) Deficiency as regard contributories ₹ 3,44,300.**
4. **Deficiency as regard contributories ₹ 29,700.**
5. **Actual liability : B ₹ 2,500; C ₹ 1,500; D ₹ 8,000; and E ₹ 1,250. Amount paid to creditors ₹ 13,250.**
6. **Actual liability : M ₹ 4,800; N ₹ 5,600; O ₹ 5,000; and P ₹ 2,500.**
7. **Deficiency as regard preference shareholders ₹ 76,000.**
8. **Amount refunded to equity shareholders @ ₹ 6 on 5,000 equity shares of ₹ 100 each, ₹ 60 paid-up.**
9. **Refund to contributories : (i) Preference shareholders ₹ 18,00,000 (including ₹ 3,00,000 dividend). (ii) Equity shareholders ₹ 1,06,175.**
10. **Liquidator's remuneration (₹ 1,530 + 343) = ₹ 1,873. Amount paid to unsecured creditors ₹ 22,875.**
11. **Liquidator's remuneration ₹ 40,750; Amount paid to contributories — @ ₹ 15.95 on 2,500 shares of ₹ 75 paid-up; @ ₹ 0.95 on 7,500 shares of ₹ 60 paid-up.**
12. **Amount collected from 3,000 equity shares ₹ 43,500; Amount refunded to fully paid-up shares ₹ 40,000; Amount refunded to partly paid-up shares ₹ 14,500.**
13. **Refunded to contributories —**
    (i) Preference shareholders ₹ 7,80,000;
    (ii) Equity shareholders ₹ 1,54,500.
    (iii) Liquidator's remuneration ₹ 24,680.

16

Banking Companies

Introduction

A bank is a commercial institution, licensed to accept deposits and acts as a safe custodian of the spendable funds of its customers. Banks are concerned mainly with the functions of banking, i.e., receiving, collecting, transferring, buying, lending, investing, dealing, exchanging and servicing (safe deposit, custodianship, agency, trusteeship) money and claims to money both domestically and internationally. The principal activities of a bank are operating accounts, receiving deposits, taking in and paying out notes and coins, and making loans. Banking activities undertaken by banks include personal banking (non-business customers), commercial banking (small and medium-sized business customers) and corporate banking (large international and multi-national corporations).

Functions of a Bank

According to Charles J. Woelfel :

A complete banking service would comprehend a variety of functions, including any of the following :

(1) Receive demand deposits and pay customers' cheques drawn against them, and operate automated teller machines (ATM);
(2) Receive time and savings deposits, issue negotiable orders of withdrawal, and pay interest thereon, as well as provide automatic transfer service (ATS) for funds from serving accounts to cover cheques;
(3) Discount notes, acceptances and bills of exchange;
(4) Supply credit to business firms with or without security, issue letters of credit and accept bills drawn thereunder;
(5) Transfer money at home and abroad;
(6) Make collections and facilitate exchanges;
(7) Issue drafts, cashier's cheques, money orders, and certify cheques;
(8) Furnish safe deposit vault service;
(9) Provide custodianship for secutieis and other valuables;

(10) Provide personal loans, credit and services to individuals, and lend or discount customer instalment receivables of vendors;
(11) Act in a fiduciary capacity for individuals, as well as establish common trust funds;
(12) Provide corporate trust services (stock transfer agent, registrar, paying agent, escrow agent, and indenture trustee);
(13) Act as factors and engage in equipment leasing;
(14) Deal in Government securities and underwrite general obligations of state and municipal securities;
(15) Invest in government and other debt securities;
(16) Act as fiscal agent or depository for the Central Government, states and subdivisions of states;
(17) Provide miscellaneous services such as place orders in securities for customers; act as insurance agent of incidental to banking transactions; serve as finder to bring buyers and sellers together; act as a travel agent and issue travellers letters of credit and traveller's cheques; provide club accounts and other special purpose accounts; act as agent for accepting service of legal process of incidental to normal banking or fiduciary transactions of the bank; act as payrole issuer; establish charitable foundations, invest in small business investment corporations and bank service corporations; deal in foreign exchange; buy and sell gold bullion under licence from the Treasury Department, and foreign coin; provide domestic and international correspondent banking services, etc.

In India, banking activities are governed by The Banking Regulation Act, 1949. As per the provision of Section 5(b) of the said Act, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, drafts, order or otherwise.

Section 5(c) defines "banking companies" as any company which transacts the business of banking in India. However, any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause.

Business of Banking Companies

As per the provision of Section 6 of the Banking Regulation Act, 1949, a banking company may engage in any one or more of the following forms of business, in addition to the business of banking. These are:

(a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hoondees, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes: the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise, the providing of safe deposit vaults; the collecting and transmitting of money and securities;
(b) acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description, including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent or secretary and treasurer of a company;
(c) contracting for public and private loans and negotiating and issuing the same;
(d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association, and the lending of money for the purpose of any such issue;
(e) carrying on and transacting every kind of guarantee and indemnity business;

(f) managing, selling and realising any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) undertaking and executing trusts;

(i) undertaking the administration of estates as executor, trustee or otherwise;

(j) establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependants or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing money for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

(l) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account, or otherwise dealing with all or any part of the property and rights of the company;

(m) acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub-section;

(n) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

Restriction on Business

It should be noted that a banking company is expressly prohibited from carrying on any kind of incidental or, allied business other than those mentioned in sub-clauses (a) to (o) of section 6 (1) of the Banking Regulation Act, 1949.

Section 8 of the Banking Regulation Act, 1949, imposes certain restrictions on the business of a banking company. These are as follows:

(i) No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realisation of security given to or held by it;

(ii) No banking company can engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange, received for collection or negotiation or with such of its business or is referred to in clause (a) of sub-section (1) of section 6.

Some Important Provisions of the Banking Regulation Act, 1949

Disposal of Non-Banking Assets (Section 9)

Notwithstanding anything contained in Section 6, no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding seven years from the acquisition thereof or from the commencement of this Act, whichever is later or any extension of such period as in this section provided, and such property shall be disposed of within such period or extended period, as the case may be :

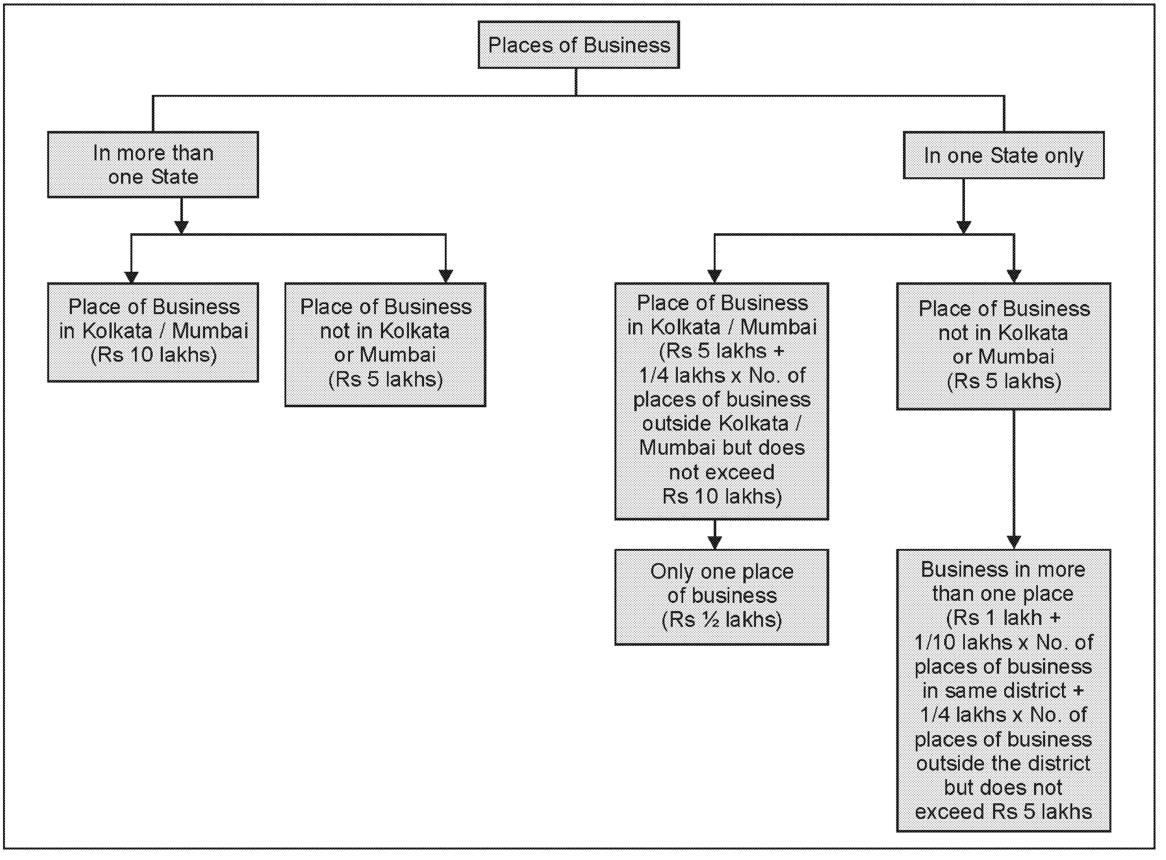
Provided that the banking company may, within the period of seven years as aforesaid, deal or trade in any such property for the purpose of facilitating the disposal thereof.

Provided further that the Reserve Bank may in any particular case extend the aforesaid period of seven years by such period not exceeding five years, where it is satisfied that such extension would be in the interest of the depositors of the banking company. The provision of this section apply only in cases where the bank acquired assets ***otherwise than for its own use.***

Minimum Capital and Reserves

As per the provision of Section 11(2) of the Banking Regulation Act, 1949, the aggregate value of ***Paid-up Capital and Reserves*** of a banking company ***incorporated outside India,*** shall not be less than 15 lakhs ₹, and if it has a place or places of business in the city of Bombay or Calcutta or both, then it shall not be less than 20 lakhs ₹. It should be noted that such sum and 20% of the profit of each year shall be kept deposited with Reserve Bank of India in cash or in the form of unencumbered approved securities, or partly in cash and partly in the form of such securities.

However, in case of a banking company which is ***incorporated in India***, the aggregate value of capital and reserves shall not be less than the stated amounts according to places of business. The provisions are stated below in the form of a diagramme.



In this respect, it should be noted that, at present, the capital (including reserves) of a bank should be at least 9% of its risk-weighted advances, the assets and off-Balance Sheet exposures. It is known as capital adequacy ratio. (It hs been discussed in detail page no. 16.58).

Restriction on Commission, Brokerage, Discount, etc., on Sale of Shares (Section 13)

No banking company shall pay out directly or indirectly by way of commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, any amount exceeding in the aggregate two and one-half per cent, of the paid-up value of the said shares.

Restrictions as to Payment of Dividend (Section 15)

No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written-off.

However, a banking company may pay dividends on its shares without writing-off :

(i) the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

(ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;

(iii) the bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

In this respect, the RBI circular dated April 23, 2004 — DBOD No. BP.BC.80/21.02.067/2003-04 is important. The relevant portion of the circular is given below :

1. Declaration of dividends by banks

The policy approach adopted by the Reserve Bank with regard to payment of dividends by banks has been recently reviewed in consultation with the Standing Technical Advisory Committee on Financial Regulation (STACFR) and it has been decided that the regulatory focus with regard to payment of dividend by banks should shift from 'quantum of dividend' to 'dividend payout ratio'. Accordingly our revised guidelines on dividends payable by banks would be as under :-

2. Eligibility criteria for declaration of dividend

(a) Only those banks, which comply with the following minimum prudential requirements, would be eligible to declare dividends without prior approval of RBI.

- i) The bank should have:
  - CRAR of at least 11 % for preceding two completed years and the accounting year for which it proposes to declare dividend.
  - Net NPA less than 3 %.
- ii) The bank should comply with the provisions of Sections 15 and 17 of the Banking Regulation Act, 1949.
- iii) The bank should comply with the prevailing regulations/ guidelines issued by RBI, including creating adequate provisions for impairment of assets and staff retirement benefits, transfer of profits to Statutory Reserves and Investment Fluctuation Reserve, etc.
- iv) The Reserve Bank should not have placed any explicit restrictions on the bank for declaration of dividends.

(b) Quantum of dividend payable

Banks, which qualify to declare dividends consequent upon compliance with the requirements set at 2(a) above would be eligible to pay dividends without obtaining the prior approval of the Reserve Bank, subject to further compliance with the following:

Bank, subject to further compliance with the following:

- (i) The dividend payout ratio does not exceed 33. 33 %.
- (ii) The proposed dividend should be payable out of the current year's profit.
- (iii) Dividend payout ratio is calculated as a percentage of 'dividend payable in a year' (excluding dividend tax) to 'net profit during the year'.
- (iv) In case the profit for the relevant period includes any extra-ordinary profits/income, the payout ratio shall be computed after excluding such extraordinary items for reckoning compliance with the prudential payout ratio ceiling of 33.33%.
- (v) The financial statements pertaining to the financial year for which the bank is declaring a dividend should be free of any qualifications by the statutory auditors, which have an adverse bearing on the profit during that year. In case of any qualification to that effect, the net profit should be suitably adjusted while computing the dividend payout ratio.

(c) Banks, which comply with the requirements at 2(a) above but desire to declare dividends higher than that specified in para 2(b) should obtain prior approval of RBI for declaration of such higher dividend. The RBI would consider the requests received from banks on a case-to-case basis.

3. Interim dividend

Banks may also declare and pay interim dividends out of the relevant accounting period's profit without prior approval of RBI if they satisfy the minimum criteria prescribed in paragraph 2(a) above, satisfy the other requirements prescribed in paragraph 2(b) above, and the cumulative interim dividend(s) are within the prudential cap on dividend payout ratio (viz. 33.33%) computed for the relevant accounting period. However, declaration and payment of interim dividends beyond this ceiling requires RBI's prior approval.

4. Banks which do not meet the eligibility criteria

In case any bank does not meet the criteria prescribed in paragraph 2(a) it should obtain the prior approval of the Reserve Bank before declaring any dividend. The requests received from these banks would be considered by the Reserve Bank on a case-to-case basis.

Statutory Reserve (Section 17)

Every banking company incorporated in India shall create a reserve fund and transfer to it at least 20% of its annual profit as disclosed in the Profit and Loss Account prepared under Section 29 and before any dividend is declared. As a further prudential measure, banks have been asked to transfer 25% of the net profit to Statutory Reserve.

Where a banking company appropriates any sum or sums from the reserve fund or the Share Premium Account, it shall report the fact to the Reserve Bank, explaining the circumstances relating to such appropriations within 21 days from the date of such appropriation.

Cash Reserve (Section 18)

Every banking company, not being a scheduled bank, has to maintain a cash reserve of at least 9% of the total of its demand and time liabilities in India, as on last Friday of the second preceding fortnight (**w.e.f. August 1, 2008**).

Cash reserve can be maintained with itself or by way of a balance in the Current Account with the Reserve Bank or by way of net balance in current accounts or in one or more of the aforesaid ways. Banks are entitled to get monthly interest on such deposits with RBI @ 6% (**w.e.f. August 1, 2008**).

Statutory Liquidity Ratio (SLR)

Apart from maintaining CRR, every bank has to maintain in India 25% w.e.f. from October 22, 1997 of the total of its demand and time liability in the form of cash, gold or unencumbered approved securities.

Restrictions on Loans and Advances (Section 20)

No banking company shall —

(a) grant any loans or advances on the security of its own shares, or

(b) enter into any commitment for granting any loan or advance to or on behalf of —

(i) any of its directors,

(ii) any firm, in which any of its directors is interested as partner, manager, employee or guarantor, or

(iii) any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956 (1 of 1956) or a Government company) of which (or the subsidiary of holding company of which) any of the directors of the banking company is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or

(iv) any individual, in respect of whom any of its directors is a partner or guarantor.

Return of Unclaimed Deposits (Section 26)

Every banking company shall, within thirty days, after the close of each year, submit a return in the precribed form and manner to the RBI of all accounts in India which have not been operated upon for 10 years. In case of fixed deposit, the period of 10 years shall be calculated from the date of expiry of such fixed period.

Books of Account

Now-a-days, the daily transactions of a bank are numerous. All these transactions are to be recorded immediately to reflect the exact position of each customer's account. Therefore, a bank has to adopt a specialised system of book-keeping, which will ensure immediate entry of numerous transactions and keep an internal check on the books of account. To achieve these objectives, a bank generally maintain a large number of subsidiary and memorandum books in addition to Principal Books of Account. We will discuss them below:

Subsidiary Books

These includes the following :

(i) Personal Ledger The bank maintains separate ledgers for different types of accounts, such as, (a) Current Accounts Ledger; (b) Savings Bank Accounts Ledger; (c) Fixed Deposit Accounts Ledger; (d) Recurring Deposit Accounts Ledger, etc. Entries are made in these ledgers directly from the vouchers.

(ii) Investments Ledger Accounts of all investments are kept in this ledger.

(iii) Loan Ledger Accounts of all the parties to whom loans have been granted are kept in this ledger.

(iv) Bills Discounted and Purchased Ledger Accounts of all the parties whose bills have been discounted and purchased are kept in this ledger.

Memorandum Books

In addition to the subsidiary books, a bank maintains various other books to facilitate its works, which do not form a part of double entry system. Some of these are :

(i) Receiving Cashier's Counter Cash Book
(ii) Paying Cashier's Counter Cash Book
(iii) Cash Balance Book.

Principal Books of Account

Cash Book and General Ledger are the principal Books of Account of any bank. Cash Book records all cash transactions and General Ledger contains Control Account of all subsidiary ledgers and different Assets and Liabilities Account. In the general ledger, accounts are arranged in such a manner that a Balance Sheet can be easily prepared.

In addition to the subsidiary books and memorandum books, bank also keep different register for recording different day-to-day matters. These registers are not part of Double Entry System. These are :

(i) Demand Draft Register
(ii) Dishonoured Cheque Register
(iii) Standing Order Register
(iv) Safe Deposit Vault Register
(v) Bill Register
(vi) Security Register
(vii) Bills for Collection Register
(viii) Jewellery Register
(ix) Letter of Credit Register

Special Features of Bank Accounting

(1) Entries are posted in the personal ledgers directly from slips, instead of being posted from the books of primary entry. In a bank, the main slips are pay-in slips and cheques. These slips are filled in by bank's customers; as such the bank saves a lot of clerical labour and cost.
(2) Trial Balance is prepared every day from the balance of accounts in the general ledger.
(3) Personal Ledgers are kept under self-balancing system. Trial balance is prepared for personal ledgers twice in a month.
(4) The slips posted into different personal ledgers every day are summarised on summary sheets, totals of which are posted to the control accounts in the general ledger.

Final Accounts

According to Section 29 of the Banking Regulation Act, 1949, every banking company is required to prepare with reference to that year a Balance Sheet and a Profit and Loss Account as on the last working day of the year in the 'Form A' and 'Form B' respectively set out in the 'Third Schedule' or as near thereto as circumstances admit.

Balance Sheet

With effect from 19th March, 1992, the Balance Sheet of a bank is to be prepared as per the new form (reproduced in ***page 16.9***). In the new form, assets and liabilities are shown vertically along with the figures of last year. In the top section capital and liabilities are shown and in the bottom section, assets are shown.

Capital and Liabilities

1. Capital This is the first item to appear under the heading 'Capital and Liabilities'. Its details are shown in **Schedule 1**.

2. Reserve and Surplus It is the second item to appear under 'Capital and Liabilities'. Statutory Reserves, Capital Reserve, Share Premium, Revenue and other Reserve; and Profit and Loss Account balances are shown under this item. The details are shown in **Schedule 2**.

3. Deposits It is the third item to appear under 'Capital and Liabilities'. Demand deposits, savings bank deposits and term deposits are shown under this item. The details are shown in **Schedule 3**.

4. Borrowings It is the fourth item to appear under 'Capital and Liabilities'. Borrowings from Reserve Bank of India, other banks, institutions and agencies are shown under this item. The details are shown in **Schedule 4**.

5. Other Liabilities and Provisions It is the last item to appear under 'Capital and Liabilities'. Bills payable, inter-office adjustments (net), interest accrued, provision for bad debts, provision for taxation are shown under this item. The details are shown in **Schedule 5**.

Assets

1. Cash and Balances with Reserve Bank of India It is the first item that appears under the heading 'Assets'. Cash in hand (including foreign currency notes); and balances with Reserve Bank of India are shown under this item. The details are shown in **Schedule 6**.

2. Balances with Banks and Money at Call and Short Notice It is the second item to appear under the heading 'Assets'. Balances with banks, money at call and short notice are shown under this item. The details are shown in **Schedule** 7. Money at call is refundable at 24 hour's notice and money at short notice is refundable at 7 day's notice.

3. Investments It is the third item to appear under the heading 'Assets'. Investment in Government securities, other approved securities, shares, debentures and bonds, subsidiaries, gold, etc., are shown under this item. The details are given in **Schedule 8**.

4. Advances It is the fourth item to appear under the heading 'Assets'. Bills purchased and discounted, cash credit, overdrafts and loans payable on demand; and term loans are shown under this item. The details are given in **Schedule 9**.

5. Fixed Assets It is the fifth item to appear under the heading 'Assets'. Premises, other fixed assets (including furniture and fixtures) are shown under this item. The details are shown in **Schedule 10**.

6. Other Assets It is the last item to appear under the heading 'Assets'. Inter- office adjustments, interest accrued, tax paid in advance, stationery and stamps, non-banking assets acquired in satisfaction of claims are shown under this item. The details are shown in **Schedule 11**.

Contingent Liabilities It is shown by way of a footnote. It represents liabilities not provided in the Balance Sheet. The details are shown in **Schedule 12**.

Profit and Loss Account

Profit and Loss Account of a banking company is also prepared in vertical form. 'Form B' of the Third Schedule of the Banking Regulation Act, 1949 is to be used for preparing Profit and Loss Account. It is divided into four sections : I. Income; II. Expenditure; III. Profit/Loss; and IV. Appropriations.

I. Income

First item of this section is ***interest earned.*** Interest/discount on advances/bills, income on investments, interest on balances with RBI etc., are shown under this item. The details are shown in **Schedule 13**. It should be noted that according to the new form, bad debts and provision for bad debts, other provisions are not deducted from the interest earned. For greater transparency in accounts, these items are shown as separate items in the Profit and Loss Account.

Second item of this section is ***other income***. Commission, exchange and brokerage, profit on sale of investments, profit on revaluation of investments, profit on sale of land, building and other assets, profit on exchange transaction, and income earned by way of dividends from subsidiaries, etc., are shown under this item. The details are shown in **Schedule 14**.

II. Expenditure

First item of this section is ***interest expended***. Interest paid on deposits, interest on RBI borrowings; interest on inter-bank borrowings, etc., are shown under this item. The details are shown in **Schedule 15**.

Second item of this section is ***operating expenses***. Salaries and wages of staff; rent, rates and taxes; printing and stationery; advertisement; depreciation on banks' properties; director's fees; auditor's fees; law charges; postage; repairs; insurance; etc., are shown under this item. The details are shown in **Schedule 16**.

Third item of this section is provisions and contingencies. Provision for bad debts, provision for taxation and other provisions are shown under this item.

III. Profit / Loss

In this section, profit / loss for the current year (difference between income and expenditure explained above) and brought forward profit / loss are shown.

IV. Appropriations

In this section, amount transferred to statutory reserve as per **Section 17**; amount transferred to other reserve; proposed dividend, etc., are shown. The balance is transferred to the Balance Sheet.

THE THIRD SCHEDULE

(See Section 29)

Form 'A'

FORM OF BALANCE SHEET

Balance Sheet of .... (here enter the name of the Banking Company)

Balance Sheet as on 31st March ____________ (year) (000's omitted)

Capital & Liabilities	Schedule No.	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other Liabilities and Provisions	5		
Total			
Assets			
Cash and balances with Reserve Bank of India	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities	12		
Bills for collection			

Form 'B'
FORM OF PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH

(000's omitted)

	Schedule No.	Year ended 31.3.... (Current Year)	Year ended 31.3.... (Previous Year)
I. **Income**			
Interest earned	13		
Other income	14		
Total			
II. **Expenditure**			
Interest expended	15		
Operating expenses	16		
Provisions and contingencies			
Total			
III. **Profit / Loss**			
Net profit / Loss (–) for the year			
Profit / Loss (–) brought forward			
Total			
IV. **Appropriations**			
Transfer to statutory reserves			
Transfer to other reserves			
Transfer to Government / proposed dividend			
Balance carried over to Balance Sheet			
Total			

NOTE : 1. The total income includes income of foreign branches at ₹. ______
2. The total expenditure includes expenditure of foreign branches at ₹. ______
3. Surplus/deficit of foreign branches ₹. ______

SCHEDULE 1 — CAPITAL

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **For Nationalised Banks**		
Capital (Fully owned by Central Government)		
II. **For Banks Incorporated Outside India**		
Capital		
(The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)		
Amount of deposit kept with the RBI under Section 11(2) of Banking Regulation Act, 1949		
Total		
III. **For Other Banks**		
Authorised Capital		
.... shares of ₹ .... each		
Issued Capital		
.... shares of ₹ .... each		
Subscribed Capital		
.... shares of ₹ .... each		
Called-up Capital		
.... shares of ₹ .... each		
Less: Calls unpaid		
Add: Forfeited shares		

SCHEDULE 2 — RESERVES & SURPLUS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **Statutory Reserves**		
Opening Balance		
Additions during the year		
Deductions during the year		
II. **Capital Reserves**		
Opening Balance		
Additions during the year		
Deductions during the year		

III. **Shares Premium**		
Opening Balance		
Additions during the year		
Deductions during the year		
IV. **Revenue and other Reserves**		
Opening Balance		
Additions during the year		
Deductions during the year		
V. **Balance in Profit and Loss Account**		
Total (I + II + III + IV + V)		

SCHEDULE 3 — DEPOSITS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
A. I. **Demand Deposits**		
(i) From banks		
(ii) From others		
II. **Savings Bank Deposits**		
III. **Term Deposits**		
(i) From banks		
(ii) From others		
Total (I + II + III)		
B. (i) Deposits of branches in India		
(ii) Deposits of branches outside India		
Total		

SCHEDULE 4 — BORROWINGS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **Borrowings in India**		
(i) Reserve Bank of India		
(ii) Other banks		
(iii) Other institutions and agencies		
II. **Borrowing outside India**		
Total (I + II)		
Secured borrowings included in I & II above — ₹.		

SCHEDULE 5 — OTHER LIABILITIES AND PROVISIONS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. Bills payable		
II. Inter-office adjustments (net)		
III. Interest accrued		
IV. Others (including provisions)		
Total		

SCHEDULE 6 — CASH AND BALANCES WITH RESERVE BANK OF INDIA

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **Cash in hand** (including foreign currency notes)		
II. **Balances with RBI**		
(i) in Current Account		
(ii) in Other Accounts		
Total (I + II)		

SCHEDULE 7 — BALANCES WITH BANKS & MONEY AT CALL & SHORT NOTICE

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **In India**		
(i) Balances with banks		
(a) in Current Accounts		
(b) in Other Deposit Accounts		
(ii) Money at call and short notice		

(a) With banks		
(b) With other institutions		
Total		
II. **Outside India**		
(i) in Current Accounts		
(ii) in Other Deposit Accounts		
(iii) Money at call and short notice		
Total		
Grand TotaL (I + II)		

SCHEDULE 8 — INVESTMENTS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **Investments in India** in		
(i) Government securities		
(ii) Other approved securities		
(iii) Shares		
(iv) Debentures and Bonds		
(v) Subsidiaries and/or joint ventures		
(vi) Others (to be specified)		
Total		
II. **Investments outside India** in		
(i) Government securities (including local authorities)		
(ii) Subsidiaries and/or joint ventures abroad		
(iii) Other investments (to be specified)		
Total		
Grand Total (I + II)		

SCHEDULE 9 — ADVANCES

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
A. (i) Bills purchased and discounted		
(ii) Cash credits, overdrafts and loans repayable on demand		
(iii) Term loans		
Total		
B. (i) Secured by tangible assets		
(ii) Covered by Bank/Government guarantees		
(iii) Unsecured		
Total		
C. I. **Advances in India**		
(i) Priority Sectors		
(ii) Public Sector		
(iii) Banks		
(iv) Others		
Total		
II. **Advances outside India**		
(i) Due from banks		
(ii) Due from others		
(a) Bills purchased and discounted		
(b) Syndicated loans		
(c) Others		
Total		
Grand Total (C.I. + C.II.)		

SCHEDULE 10 — FIXED ASSETS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. **Premises**		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		

II. **Other Fixed Assets (including furniture and fixtures)**		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Total (I + II)		

SCHEDULE 11 — OTHER ASSETS

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. Inter-office adjustments (net)		
II. Interest accrued		
III. Tax paid in advance / tax deducted at source		
IV. Stationery and stamps		
V. Non-banking assets acquired in satisfaction of claims		
VI. Others @		
Total		

@ In case there is any unadjusted balance of loss, the same may be shown under this item with appropriate foot-note.

SCHEDULE 12 — CONTINGENT LIABILITIES

	As on 31.3. ... (Current Year)	As on 31.3. ... (Previous Year)
I. Claims against the bank not acknowledged as debts		
II. Liability for partly paid investments		
III. Liability on account of outstanding forward exchange contracts		
IV. Guarantees given on behalf of constitutents		
(a) In India		
(b) Outside India		
V. Acceptances, endorsements and, other obligations		
VI. Other items for which the bank is contingently liable		
Total		

SCHEDULE 13 — INTEREST EARNED

	Year ended 31.3.... (Current Year)	Year ended 31.3.... (Previous Year)
I. Interest/discount on advances / bills		
II. Income on investments		
III. Interest on balances with Reserve Bank of India and other inter-bank funds		
IV. Others		
Total		

SCHEDULE 14 — OTHER INCOME

	Year ended 31.3. ... (Current Year)	Year ended 31.3. ... (Previous Year)
I. Commission, exchange and brokerage		
II. Profit on sale of investments		
Less: **Loss on sale of investments**		
III. Profit on revaluation of investments		
Less: **Loss on revaluation of investments**		
IV. Profit on sale of land, buildings and other assets		
Less : Loss on sale of land, buildings and other assets		
V. Profit on exchange transactions		
Less: **Loss on exchange transactions**		
VI. Income earned by way of dividends etc., from subsidiaries / companies and/or joint ventures abroad / in India		
VII. Miscellaneous Income		
Total		

Note : Under items II to V loss figures may be shown in brackets

SCHEDULE 15 — INTEREST EXPENDED

	Year ended 31.3. ... (Current Year)	Year ended 31.3. ... (Previous Year)
I. Interest on deposits		
II. Interest on Reserve Bank of India / inter-bank borrowings		
III. Others		
Total		

SCHEDULE 16 — OPERATING EXPENSES

		Year ended 31.3. ... (Current Year)	Year ended 31.3. ... (Previous Year)
I.	Payments to and provisions for employees		
II.	Rent, taxes and lighting		
III.	Printing and stationery		
IV.	Advertisement and publicity		
V.	Depreciation on bank's property		
VI.	Directors' fees, allowances and expenses		
VII.	Auditors' fees and expenses (including branch auditors' fees and expenses)		
VIII.	Law charges		
IX.	Postages, telegrams, telephones, etc.		
X.	Repairs and maintenance		
XI.	Insurance		
XII.	Other expenditure		
	Total		

Guidelines of RBI for Compilation of Financial Statements
Balance Sheet

Item	Schedule	Coverage	Notes and Instructions for compilation
(1)	**(2)**	**(3)**	**(4)**
Capital	I	**Nationalised Banks** Capital (fully owned by Central Government)	The capital owned by Central Government as on the date of the Balance Sheet, including contribution from Government, if any, for participating in World Bank Projects, should be shown.
		Banking Companies incorporated outside India.	(i) The amount brought in by banks by way of start-up capital as prescribed by RBI, should be shown under this head. (ii) The amount or deposits kept with RBI under sub-section 2 of Section 11 of the Banking Regulation Act, 1949 should also be shown.
		Other Banks (Indian) Authorised capital (... Shares of ₹ ... each) Issued Capital (... Shares of ₹ ... each) Subscribed Capital (... Shares of ₹ ... each) Called-up Capital (... Shares of ₹ ... each) *Less* **: Calls unpaid** *Add* **: Forfeited shares: Paid-up Capital**	Authorised, Issued, Subscribed, Called-up Capitals should be given separately. Calls-in-arrears will be deducted from Called- up Capital while the paid-up value of forfeited shares should be added, thus arriving at the paid-up capital. The necessary items which can be combined should be shown under one head, for instance, "Issued and Subscribed Capital". **Notes :** General The changes in the above items, if any, during the years, say, fresh contribution made by the Government, fresh issue of capital, capitalisation of reserves, etc., may be explained in the notes.
Reserves and Surplus	2	(I) **Statutory Reserves**	Reserves created in terms of Section 17 or another section of Banking Regulation Act, must be separately disclosed.
		(II) **Capital Reserves**	The expression 'capital reserve' shall not include any amount regarded as free for distribution through the Profit and Loss Account. Surplus on revaluation should be treated as Capital Reserves. Surplus on translation of the financial statements of foreign branches (which includes fixed assets also) is not a revaluation reserve.
		(III) **Share Premium**	Premium on issue of share capital may be shown separately under this head.
		(IV) **Revenue and other Reserves**	The expression 'Revenue Reserve' shall mean any reserve other than capital reserve. This item will include all reserves, other than those separately classified. This expression 'reserve' shall not include any amount, written-off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.
		(V) **Balance of Profit**	Includes balance of profit after appropriation. In case of loss the balance may be shown as a deduction. **Notes :** General Movement in various categories of reserves should be shown as indicated in the schedule.

Deposits	3	A.(I) **Demand Deposits** (i) from banks (ii) from others	Includes all bank deposits repayable on demand. Includes all demand deposits of the non-banking sectors. Credit balances in overdrafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates, certificate of deposits, etc., are to be included under this category.
		(II) **Saving Bank Deposits**	Includes all savings bank deposits (including inoperative savings bank accounts).
		(III) **Term Deposits** (i) from banks (ii) from others	Includes all types of bank deposits repayable after specified term. Includes all types of deposits of the non-banking sector, repayable after a specified term. Fixed deposits, cumulative and recurring deposits, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, foreign currency non- resident deposit accounts, etc., are to be included under this category.
		B.(i) **Deposits of branches in India** (ii) **Deposits of branches outside India**	The total of these two items will agree with the total deposits. **Notes :** General (a) Interest payable on deposits which is accrued but not due should not be included but shown under other liabilities. (b) Matured time deposits and cash certificates, etc., should be treated as demand deposits. (c) Deposits under special schemes should be included under the term deposits, if they are not payable on demand. When such deposits have matured for payment they should be shown under demand deposits. (d) Deposits from banks will include deposits from the banking system in India, co-operative banks, foreign banks, which may or may not have presence in India.
Borrowings	4	(I) **Borrowings in India** (i) Reserve Bank of India (ii) Other Banks (iii) Other institutions and agencies	Includes borrowing / refinance obtained from Reserve Bank of India. Includes borrowings / refinance obtained from commercial banks (including co-operative banks). Includes borrowings / refinance obtained from Industrial Development Bank of India, Export-Import of Bank of India, National Bank for Agriculture and Rural Development and other institutions, agencies (including liability against participation certificates, if any).
		(II) **Borrowings outside India**	Includes borrowings of Indian branches abroad as well as borrowing of foreign branches.
		Secured borrowings included above	This item will be shown seaprately. Includes secured borrowings / refinance in India and outside India. **Notes :** General (i) The total of I and II will agree with the total borrowings shown in the Balance Sheet. (ii) Inter-office transactions should not be shown as borrowings. (iii) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc., should be classified depending upon documentation, as ‘deposits’, ‘borrowings’, etc. (iv) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head ‘Borrowings’. Hence, advances will be shown at the gross amount on the assets side.

Other Liabilities and Provisions	5	I. **Bills Payable**	Includes drafts, telegraphic transfers, traveller cheques, mail transfers payable, pay slips, bankers cheques and other miscellaneous items.
		II. **Inter-office Adjustments**	The inter-office adjustments balance, if the credit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here.
		III. **Interest Accrued**	Includes interest accrued but not due on deposits and borrowings.
		IV. **Others (including provisions)**	Includes net provision for income tax and other taxes like interest tax (less advance payment, tax deducted at source, etc.,) surplus in aggregate in provisions for Bad Debts Provision Account, surplus in aggregate in provisions for depreciation in securities, contingency funds which are not disclosed as reserves but are actually in the nature of reserves, proposed dividend/transfer to Government, other liabilities which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purpose, unexpired discount, outstanding charges like rent, conveyance, etc. Certain types of deposits like staff security deposits, margin deposits, etc., where the repayment is not free, should also be included under this head. **Notes :** General (i) For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance should only be shown, representing mostly items in transit and unadjusted items. (ii) the interest accruing on all deposits, whether the payment is due or not, should be treated as a liability. (iii) it is proposed to show only pure deposits under the head 'deposits'; and hence, all surplus provisions for bad and doubtful debts, contingency funds, secret reserves, etc., which are not netted off against the relative assets, should be brought under the head 'others' (including provisions).
Cash and Balances with the Reserve Bank of India	6	I. **Cash in hand (including foreign currency notes)**	Includes cash in hand, including foreign currency notes and also of foreign branches in the case of banks having such branches.
		II. **Balance with RBI** (i) in Current Account (ii) in Other Accounts	
Balance with banks and money at call and short notice	7	I. **In India** (i) Balance with Banks (a) in current accounts (b) in other deposit accounts	Includes all balance with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately.
		(ii) Money at call and short notice (a) with banks (b) with other institutions	Includes deposits repayable within 15 days notice, lent in the inter-bank call money market.
		II. **Outside India** (i) Current accounts (ii) Deposits	Includes balances held by foreign branches and balances held by Indian branches of the banks outside India. Balance held with foreign branches by other branches of the bank, should not be shown under this head but should be included in the inter-branch accounts. The amounts held in 'current accounts' and 'deposit accounts should be shown separately.
		(iii) Money at call and short notice	Includes deposits usually classified in foreign currencies as money at call and short notice.
Investment	8	I. **Investment in India** (i) Government securities	Includes Central and State Government securities and Government treasury bills. These securities should be at the book value. However, the difference between the book value and market value should be given in the notes to the Balance Sheet.

		(ii) Other approved securities	Securities other than Government securities, which according to the Banking Regulation Act, 1949, are treated as approved securities, should be included here.
		(iii) Shares	Investment in shares of companies and corporations not included in item (ii) should be included here.
		(iv) Debentures and Bonds	Investments in debentures and bonds of Companies, Corporations not included in item (ii) should be included here.
		(v) Investments in subsidiaries/joint ventures	Investment in subsidiary / joint ventures (including R.R.Bs) should be in included here.
		(vi) Others	Includes general investments, if any, like gold, commercial paper and other instruments in the nature of shares / debentures / bonds.
		II. **Investment outside India**	
		(i) Government securities (including local authorities).	All foreign Government securities including securities issued by lcoal authorities may be classified under this head.
		(ii) Subsidiaries and/or joint ventures abroad	All investments made in the share capital of subsidiaries, floated outside India and/or joint ventures abroad, should be classified under this head.
		(iii) Others	All other investments outside India may be shown under this head.
Advances	9	A. (i) Bills purchased and discounted (ii) Cash credits, overdrafts and loans repayable on demand (iii) Term loans	In classification under Section 'A', all outstandings — in India as well as outside — less provisions made, will be classified under three heads as indicated, and both secured and unsecured advances will be included under these heads, including overdue instalments.
		B. (i) Secured by tangible assets	All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India and outside India.
		(ii) Covered by Bank / Government Guarantee	Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC & ECGC are to be included.
		(iii) Unsecured	All advances not classified under (i) and (ii) will be included here. Total of 'A' should tally with the total of 'B'.
		C.I. **Advances in India** (i) Priority sectors (ii) Public sector (iii) Banks (iv) Others	Advances should be broadly classified into 'Advances in India' and 'Advances outside India'. Advances in India will be further classified on the sectorial basis as indicated.
		C.II. **Advances outside India** (i) Due from banks (ii) Due from others (a) Bills purchased and discounted (b) Syndicated loans (c) Others	Advances to sectors which for the time being are classified as priority sectors according to the instructions of the Reserve Bank are to be classified under the head 'Priority sectors'. Such advances should be excluded from the item (ii) i.e., advance to public sector. Advances to Central and State Governments and other Government undertakings including Government companies and corporations, which are, according to the statutes, to be treated as Public sectors companies, are to be included in the category 'Public sector'. All advances to the banking sector including co-operative banks, will come under the head 'Banks'. All the remaining advances will be included under the head 'Others' and typically this category will include non-priority advances to the private, joint and co-operative sectors. **Notes :** General (i) The gross amount of advances including refinance and rediscounts but excluding provisions made to the satisfaction of auditors, should be shown as advances. (ii) Term loans will be loans not repayable on demand. (iii) Consortium advances would be shown net of share from other participating banks/institutions.

Fixed Assets	10	I. **Premises** (i) At cost as on 31st March of the preceding year (ii) Addition during the year (iii) Deductions during the year (iv) Depreciation to due	Premises wholly or partly owned by the banking company for the purpose of business, including residential premises should be shown against 'premises'. In the case of premises and other fixed assets, the previous balance, additions thereto, deductions therefrom, during the year, and also the total depreciation written-off should be shown. Where sums have been written-off on reduction of capital and revaluation of assets, every Balance Sheet after the first Balance Sheet, subsequent to the reduction or revaluation should show the revised figures for a period of five years, with the date and amount of revision made.
		II. **Other Fixed Assets (including furniture and fixtures)** (i) At cost on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	Motor vehicles and all other fixed assets other than premises but including furniture and fixtures should be shown under this head.
Other Assets	11	I. **Inter-office Adjustment (net)**	The inter-office adjustment balance, if in debit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balance of inter-office adjustment accounts, all connected inter-office accounts should be aggregated and the net balance, if in debit, only should be shown, representing monthly items in transit and unadjusted items.
		II. **Interest Accrued**	Interest accrued but not due on investments and, advances and interest due but not collected on investment, will be the main components of this item. As banks normally debit the borrowers' account with the interest due on the Balance Sheet date, usually there may not be any amount of interest due on advances. Only such interest as can be realised in the ordinary course should be shown under this head.
		III. **Tax paid in advance / tax deducted at source**	The amount of tax deducted at source on securities, advance tax paid etc. to the extent that these items are not set off against relative tax provision should be shown against this item.
		IV. **Stationery and Stamps**	Only exceptional items of expenditure on stationery like bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written-off over a period of time, should be shown here. The value should be on a realistic basis and cost escalation should not be taken into account, as these items are for internal use.
		V. **Non-banking assets acquired in satisfaction of claims**	Immovable properties/tangible assets acquired in satisfaction of claims are to be shown under this head.
		VI. **Others**	This will include items like claims which have not been met, for instance, clearing items, debit items representing addition to assets or reduction in liabilities, which have not been adjusted for technical reasons, want of particulars, etc., advances given to staff by a bank as an employer and not as a banker, etc. Items which are in the nature of expenses, which are pending adjustments, should be provided for and the provision netted against this item, so that only realisable value is shown under this head. Accrued income other than interest may also be included here.
Contingent Liabilities	12	I. **Claims against the bank not acknowledged as debts** II. **Liabilities for partly paid investments**	Liabilities on partly paid shares, debentures, etc., will be included in this head.

		III. **Liabilities on account of outstanding forward exchange contracts**	Outstanding forward exchange contracts may be included here.
		IV. **Guarantees given on behalf of constituents** (i) in India (ii) outside India	Guarantees given for constituents in India and outside India may be shown separately.
		V. **Acceptances, endorsement and other obligations**	This item will include letters of credit and bills accepted by the bank on behalf of customers.
		VI. **Other items for which the Bank is contingently liable**	Arrears of cumulative dividends, bills rediscounted under under- writing contracts, estimated amounts of contracts remaining to be executed on Capital Account and not provided for, etc., are to be included here.
Bills for Collection			Bills and other items in the course of collection and not adjusted will be shown against this item in summary version only, a separate schedule is proposed.

Profit and Loss Account

Interest earned	13	I. **Interest/discount on advances/ bills**	Includes interest and discount on all types of loans and advances, cash credit, demand loans, overdrafts, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), over interest and also interest subsidy, if any, relating to advances/bills.
		II. **Income on investments**	Includes all income derived from the investment portfolio by way of interest and dividend.
		III. **Interest on balances with Reserve Bank of India and other inter-bank funds**	Includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.
		IV. **Others**	Includes any other interest / discount income not included in the above heads.
Other Income	14	I. **Commission, exchange and brokerage**	Includes all remuneration on services such as commission on collections, commission/exchanges on remittances and transfers, commission on letters of credit, letting out of lockers and guarantees, commission on Government business, commission on other permitted agency business including consultancy and other services, brokerage, etc., on securities. It does not include foreign exchange income.
		II. **Profit on sale of investments,** *Less*: Loss on sale of investments III. **Profit on revaluation of investments**. *Less*: **Loss on revaluation of investments** IV. **Profit on sale of land, buildings and other assets.** *Less*: Loss on sale of land, buildings and other assets.	Includes profit/loss on sale of securities, furniture, land and buildings, motor vehicle, gold, silver, etc. Only the net position should be shown. If the net position is a loss, the amount should be shown as a deduction. The net profit/loss on revaluation of assets may also be shown under this item.
		V. **Profit on exchange transactions.** *Less*: Loss on exchange transactions VI. **Income earned by way of dividends etc., from subsidiaries, companies, joint ventures abroad / in India.**	Includes profit/loss on dealing in foreign exchange, all income earned by way of foreign exchange, commission and charges on foreign exchange transactions excluding interest which will be shown under interest. Only the net position should be shown. If the net position is a loss, it is to be shown as a deduction.
		VII. **Miscellaneous income**	Includes recoveries from constituents for godown rents, income from bank's properties, security charges, insurance, etc., and any other miscellaneous income. In case, any item under this head exceeds one percentage of the total income, particulars may be given in the notes.

Interest Expended 15	I. **Interest on deposits**	Includes interest paid on all types of deposits including deposits from banks and other institutions.
	II. **Interest on Reserve Bank of India / inter-bank borrowings**	Includes discount/interest on all borrowings and refinance from the Reserve Bank of India and other banks.
	III. **Others**	Includes discount/interest on all borrowings/refinance from financial instituions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.
Operating Expenses 16	I. **Payments to and provisions for employees**	Includes staff salaries/wages, allowances, bonus, and other staff benefits, like provident fund, pension, gratuity, liveries to staff, leave fare concessions, staff welfare, medical allowance to staff, etc.
	II. **Rent, taxes and lighting**	Includes rent paid by the banks on buildings and other municipal and other taxes paid (excluding income-tax and interest tax) electricity and other similar charges and levies. House rent allowance and other similar payments to staff should appear under the head 'Payments to and Provisions for Employees'.
	III. **Printing and Stationery**	Includes books and forms, and stationery used by the bank and other printing charges, which are not incurred by way of publicity expenditure.
	IV. **Advertisement and Publicity**	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.
	V. **Depreciation on bank's property**	Includes depreciation on bank's own property, motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non-banking assets, etc.
	VI. **Directors' fees, allowances and expenses**	Includes sitting fees and all other items of expenditure incurred on behalf of the directors. The daily allowance, hotel charges, conveyance charges, etc. which though in the nature of reimbursement of expenses incurred, may be included under this head. Similar expenses of Local Committee members may also be included under this head.
	VII. **Auditor's fees and expenses (including branch auditor's fees and expenses)**	Includes the fees paid to the statutory auditors and branch auditors for the professional services rendered and also all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by the banks themselves for internal inspections and audits and other services, the expenses incurred in that context including fees may not be included under this head but should be shown under 'other expenditure'.
	VIII. **Law charges**	All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.
	IX. **Postage, telegraphs, telephones, etc.**	Includes all postal charges like stamps, telegrams, telephones, teleprinter, etc.
	X. **Repairs and maintenance**	Includes repairs to bank's property, their maintenance charges, etc.
	XI. **Insurance**	Includes insurance charges on bank's property, insurance premia paid to Deposit Insurance and Credit Guarantee Corporation, etc., to the extent they are not recovered from the concerned parties.
	XII. **Other expenditure**	All expenses other than those not included in any of the other heads, like, licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc., may be included under this head. In case, any particular item under this head exceeds one percentage of the total income, the particulars may be given in the notes.
Provisions and Contingencies		Includes all provisions made for bad and doubtful debts, provisions for taxation, provisions for diminution in the value of investments, transfers to contingencies and other similar items.

Disclosure of Accounting Policies

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

(1) General

The accompanying financial statements have been prepared on the historical cost and conform to the statutory provisions and practices prevailing in the country.

(2) Transactions involving Foreign Exchange

(a) Monetary assets and liabilities have been translated at the exchange rates, prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.

(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates, ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.

(c) Profit or loss on pending forward contracts have been accounted for.

(3) Investments

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

(b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 per cent of the share capital) have been accounted for on the historical cost basis.

(c) All other investments are valued at the lower of cost or market value.

(4) Advances

(a) Provisions for doubtful advances have been made to the satisfaction of the auditors:
  (i) In respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies;
  (ii) In respect of general advances, as a percentage of total advances taking into account the guidelines issued by the Government of India and the Reserve Bank of India.

(b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have been included under "Other Liabilities and Provisions".

(c) Provisions have been made on a gross basis. Tax relief, which will be available when the advance is written-off, will be accounted for in the year of write-off.

(5) Fixed Assets

(a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the value determined on the basis of such revaluation made by the professional values, profit arising on revaluation has been credited to Capital Reserve.

(b) Depreciation has been provided for on the straight line/diminishing balance method.

(c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent of revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

(6) Staff Benefits

Provisions for gratuity/pension benefits to staff have been made on an accrual/casual basis. Separate funds for gratuity/pension have been created.

(7) Net Profit

(a) The net profit disclosed in the Profit and Loss Account is after :
  (i) provisions for taxes on income, in accordance with the statutory requirements.
  (ii) provisions for doubtful advances.
  (iii) adjustments to the value of "current investments" in Government and other approved securities in India, valued at lower of cost or market value.
  (iv) transfers to contingency funds.
  (v) other usual or necessary provisions.

(b) Contingency funds have been grouped in the Balance Sheet under the head "Other Liabilities and Provisions".

Some Special Transactions

Rebate on Bills Discounted

When a bank discounts a bill, Bills Discounted and Purchased Account is debited with the full value of the bill and Current Account (customer's) is credited with the net proceeds and Interest and Discount Account is credited with the amount of total discount of the bill. Discount represents the ***interest on bill value for the unexpired period of the bill*** (difference between the date of maturity and date of discounting). It sometimes happen that on the closing day of the accounting year, the bill in question has not matured.

In this case, discount relating to the unexpired term (difference between the date of closing of accounts and maturity date) of the bill cannot be taken as income of the current year. It must be carried forward to next year. The account to which the discount relating to the unexpired term of the bill is transferred, is called 'Rebate on Bills Discounted Account'.

The following ***journal entry*** is passed for this adjustment :

Interest and Discount Account Dr.

To Rebate on Bills Discounted Account

It appears in the Balance Sheet under 'Capital and Liabilities'. At the commencement of the next accounting year, it is transferred to Interest and Discount Account by means of a reverse entry.

Illustration 1

On 1st February, 2016 a bill of ₹ 3 lakhs is discounted @ 12% p.a. The due date of the bill is 30th April, 2016. Pass necessary Journal Entries in the books of the bank assuming that the bill is collected on due date. Account year closing on 31st March, 2016.

Solution

In the books of Bank
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 Feb. 1	Bills Discounted and Purchased A/c Dr.		3,00,000	
	To Client A/c			2,91,000
	To Interest and Discount A/c (Note 1)			9,000
	(Being the discounting of a bill accepted by .... and due on .... @ 12% p.a.)			
	At maturity on 30th April, 2016, the bank will collect the full amount of the bill and the entry will be:			
	Cash A/c Dr.		3,00,000	
	To Bills Discounted and Purchased A/c			3,00,000
	(Being the bill collected at maturity)			
	Apparently, it appears that ₹ 9,000 discount is the income of 2015-16. But actually 2 months', interest is the income of 2015-16 and 1 month's, interest is related to 2016-17. Therefore, on 31st March 2016, the adjusting entry will be :			
	Interest and Discount A/c Dr.		3,000	
	To Rebate on Bills Discounted A/c (Note 2)			3,000
	(Being the proportionate discount not earned in 2015-16 carried forward through Rebate on Bills Discounted Account)			
	Interest and Discount A/c Dr.		6,000	
	To Profit and Loss A/c			6,000
	(Being transfer of Interest and Discount Account balance to Profit and Loss Account)			

Working Notes : (1) Discount for 3 months = ₹ 3,00,000 × 12/100 × 3/12 = ₹ 9,000.

(2) Rebate on Bills Discounted = ₹ 9,000/3 × 1 = ₹ 3,000.

Illustration 2

Calculate rebate on bills discounted as on 31st March, 2016.

Date of Bill	Amount (₹)	Period	Rate of Discount
15.1.2016	25,000	5 Months	8%
10.2.2016	15,000	4 Months	7%
25.2.2016	20,000	4 Months	7%
20.3.2016	30,000	3 Months	9%

Solution **Calculation of Rebate on Bills Discounted**

Date of Bill	Period	Due date (after days of grace)	Days beyond 31.3.2016	Amount of the Bill	Rate of Discount	Amount of Discount
15.1.2016	5 Months	18.6.2016	79	25,000	8%	432.88
10.2.2016	4 Months	13.6.2016	74	15,000	7%	212.88
25.2.2016	4 Months	28.6.2016	89	20,000	7%	341.37
20.3.2016	3 Months	23.6.2016	84	30,000	9%	621.37
						1,608.50

Working Notes : (1) Calculation of Days beyond 31.3.2016 :

April		May		June	=	Total No. of Days
30	+	31	+	18	=	79
30	+	31	+	13	=	74
30	+	31	+	28	=	89
30	+	31	+	23	=	84

(2) Journal Entry :

Interest and Discount A/c	Dr.	1,.608.50	
To Rebate on Bills Discounted A/c			1,608.50

Illustration 3

The following is an extract from the Trial Balance of Dream Bank Ltd as at 31st March, 2006 :

Rebate on bills discounted as on 1.4.2005	68,259 (Cr.)
Discount received	1,70,156 (Cr.)

Analysis of the bills discounted reveals as follows :

Amount (₹)	Due Date
2,80,000	June 1, 2006
8,72,000	June 8, 2006
5,64,000	June 21, 2006
8,12,000	July 1, 2006
6,00,000	July 5, 2006

You are required to find out the amount of discount to be credit to Profit and Loss Account for the year ending 31st March, 2006 and pass Journal Entries. The rate of discount may be taken at 10% per annum.

[C.A. (PE-II) — November, 2006]

Solution **Calculation of Rebate on Bills Discounted**

Due Date of the Bill	Days beyond 31.3.2006 (Note 1)	Amount of the Bill (₹)	Rate of Discount	Amount of Discount (₹)
1.6.2006	62	2,80,000	10%	4.756
8.6.2006	69	8,72,000	10%	16,484
21.6.2006	82	5,64,000	10%	12,671
1.7.2006	92	8,12,000	10%	20,467
5.7.2006	96	6,00,000	10%	15,781
				70,159

Amount to be Credited to Profit and Loss Account

Particulars	₹
Discount received	1,70,156
Add: Balance of Rebate on bills discounted on 1.4.2005	68,259
	2,38,415
Less: Rebate on bills discounted on 31.3.2006 (unexpired discount)	70,159
Amount transferred to Profit and Loss Account	1,68,256

In the books of Dream Bank Ltd
Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2006 March 31	Rebate on Bills Discounted A/c Dr. To Interest and Discount A/c (Being the transfer of opening balance to Rebate on Bills Discounted Account to Interest and Discount Account)		68,259	68,259

Interest and Discount A/c Dr. To Rebate on Bills Discounted A/c (Being the provision for unexpired discount as on 31.3.2011)		70,159	70,159
Interest and Discount A/c Dr. To Profit and Loss A/c (Being the transfer of Interest and Discount Account balance to Profit and Loss Account)		1,68,256	1,68,256

Working Note : (1) Calculation of Days beyond 31.3.2011 :

April		May		June		July		Total No. of Days
30	+	31	+	1	+	—	=	62
30	+	31	+	8	+	—	=	69
30	+	31	+	21	+	—	=	82
30	+	31	+	30	+	1	=	92
30	+	31	+	30	+	5	=	96

Illustration 4

The following particulars are extracted from the records of M/s. Engco Bank Limited for the year ended 31st March, 2011 :

Particulars	₹
Rebate on bills discounted (not due on March 31, 2010)	60,610
Discount received	6,10,800
Bills discounted	24,42,250

An analysis of the bills discounted is as follows :

Amount (₹)	Due Date
3,75,000	April 15, 2011
4,90,000	May 6, 2011
2,45,000	June 1, 2011
3,68,000	June 20, 2011
4,85,000	July 4, 2011

The rate of discount is 12% per annum.

You are required to :

(i) Calculate rebate on bills discounted as on 31st March, 2011.

(ii) Determine the amount of discount to be credited to the Profit and Loss Account for the year ended 31st March, 2011.

(iii) Show the necessary Journal Entries in the books of M/s. Engco Bank Ltd as on 31st March, 2011.

[C.A. (IPCC) — November, 2011]

Solution

(i) Calculation of Rebate on Bills Discounted

Due Date of Bill	Days beyond 31.3.2011 (Note 1)	Amount of the Bill	Rate of Discount per annum	Amount of Discount (₹)
15.04.2011	15	3,75,000	12%	1,849
06.05.2011	36	4,90,000	12%	5,800
01.06.2011	62	2,45,000	12%	4,994
20.06.2011	81	3,68,000	12%	9,800
04.07.2011	95	4,85,000	12%	15,148
Total Rebate on Bills Discounted to be Carried Forward				37,591

(ii) Amount of Discount to be Credited to Profit and Loss Account

Particulars	₹
Discount received	6,10,800
Add: Balance of Rebate on bills discounted on 1.4.2010	60,610
	6,71,410
Less: Rebate on bills discounted on 31.3.2011 (unexpired discount)	37,591
Amount to be transferred to Profit and Loss Account	6,33,819

Solution

In the books of Engco Bank Ltd

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2011 March 31	Rebate on Bills Discounted A/c Dr. To Interest and Discount A/c Being the transfer of opening balance of Rebate on Bills Discounted Account to Interest and Discount Account)		60,610	60,610
	Interest and Discount A/c Dr. To Rebate on Bills Discounted A/c (Being the provision for unexpired discount as on 31.3.2011)		37,591	37,591
	Interest and Discount A/c Dr. To Profit and Loss A/c (Being the amount transferred to Profit and Loss Account)		6,33,819	6,33,819

Working Note : (1) Calculation of Days Beyond 31.3.2011

April		May		June		July		Total No. of Days
15	+	0	+	0	+	0	=	15
30	+	6	+	0	+	0	=	36
30	+	31	+	1	+	0	=	62
30	+	31	+	20	+	0	=	81
30	+	31	+	30	+	4	=	95

Illustration 5

As on 31st March, 2016, the books of the Hercules Bank, including among others, had the following balances:

Rebate on bills discounted (1.4.2015) ₹ 3,20,000; Discount received ₹ 46,00,000; Bills discounted and purchased ₹ 3,15,47,000.

Throughout 2015-16, the bank's rate for discounting has been 18%. On investigation and analysis, the average due date for the bills discounted and purchased is calculated as 15th May 2016 and that of the bills for collection as 15th April, 2016. Show the calculation of the amount to be credited to the Bank's Profit and Loss Account under discount earned for the year 2015-16. Also show the Journal Entries required to adjust the above-mentioned accounts. ***[C.A. (Inter) — Adapted]***

Solution

Unexpired Discount = $3{,}15{,}47{,}000 \times \frac{18}{100} \times \frac{45^{*}}{365} = ₹\ 7{,}00{,}084$

Amount to be Credited to Profit and Loss Account

Particulars	₹
Discount received	46,00,000
Add: Balance in Rebate Account as on 1.4.2015	3,20,000
	49,20,000
Less: Rebate on Bills Discounted (31.3.2016 — unexpired discount)	7,00,084
Amount transferred to Profit and Loss Account	42,19,916

* April : 30 days + May : 15 days = 45 days.

In the books of Hercules Bank

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2016 March 31	Rebate on Bills Discounted A/c Dr. To Interest and Discount A/c (Being the transfer of opening balance in the Rebate on Bills Discounted Account)		3,20,000	3,20,000
	Interest and Discount A/c Dr. To Rebate on Bills Discounted A/c (Being the provision for unexpired discount as on 31.3.2005)		7,00,084	7,00,084
	Interest and Discount A/c Dr. To Profit and Loss A/c (Being the transfer of Interest and Discount Account balance to Profit and Loss Account)		42,19,916	42,19,916

Illustration 6

The following particulars are extracted from the (Trial Balance) Books of the M/s Commercial Bank Ltd for the year ending 31st March, 2003 :

	₹
(i) Interest and Discounts	1,96,62,400
(ii) Rebate on Bills Discounted (balance on 1.4.2002)	65,040
(iii) Bills Discounted and Purchased	67,45,400

It is ascertained that proportionate discount not yet earned on the Bills Discounted which will mature during 2003-04 amounted to ₹ 92,760.

Pass the necessary journal entries with narration adjusting the above and show : (a) Rebate on Bill Discount Account; and (b) Interest and Discount Account in the ledger of the Bank. ***[C.A. (PE-II) — November, 2003]***

Solution

In the books of M/s Commercial Bank Ltd
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2003 March 31	Rebate on Bills Discounted A/c Dr. To Interest and Discount A/c (Being the transfer of opening balance of Rebate on Bills Discounted Account to Interest and Discount Account)		65,040	65,040
	Interest and Discount A/c Dr. To Rebate on Bills Discounted A/c (Being the provision for unexpired discount as on 31.3.2003)		92,760	92,760
	Interest and Discount A/c Dr. To Profit and Loss A/c (Being the transfer of Interest and Discount Account balance to Profit and Loss Account)		1,96,34,680	1,96,34,680

Ledger of M/s Commercial Bank Ltd
Dr. Rebate on Bills Discounted Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2003 March 31	To Interest and Discount A/c	65,040	2002 April 1	By Balance b/d	65,040
"	To Balance c/d	92,760	2003 March 31	By Interest and Discount A/c (Rebate provided)	92,760
		1,57,800			1,57,800

Dr. Interest and Discount Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2003 March 31	To Rebate on Bills Discounted A/c	92,760	2003 March 31	By Rebate on Bills Discounted A/c	65,040
"	To Profit and Loss A/c (Transfer)	1,96,34,680	"	By Bills Discounted and Purchased A/c	1,96,62,400
		1,97,27,440			1,97,27,440

Illustration 7

On 31st March, 1997, Uncertain Bank Ltd had a balance of ₹ 9 crores in "rebate on bills discounted" account. During the year ended 31st March, 1998, Uncertain Bank Ltd discounted bills of exchange of ₹ 4,000 crores charging interest at 18% per annum, the average period of discount being for 73 days. Of these, bills of exchange of ₹ 600 crores were due for realisation from the acceptors/customers after 31st March, 1998, the average period outstanding after 31st March, 1998 being 36.5 days.

Uncertain Bank Ltd asks you to pass journal entries and show the ledger accounts pertaining to :

(i) Discounting of Bills of Exchange; and

(ii) Rebate on Bills Discounted. ***[C.A. (Inter) — May, 1998]***

Solution

In the books of Uncertain Bank Ltd
Journal

Date	Particulars	L.F.	Dr. ₹ in Crores	Cr. ₹ in Crores
1998 March 31	Rebate on Bills Discounted A/c Dr. To Interest and Discount A/c (Being the transfer of opening balance to Rebate on Bills Discounted Account)		9.00	9.00

Bills Purchased and Discounted A/c Dr. To Client A/c To Interest and Discount A/c (Note 1) (Being the discounting of bills during the year)		4,000	 3,856 144
Interest and Discount A/c (Note 2) Dr. To Rebate on Bills Discounted A/c (Being the provision for unexpired discount as on 31.3.1998)		10.80	 10.80
Interest and Discount A/c Dr. To Profit and Loss A/c (Being the transfer of Interest and Discount Account balance to Profit and Loss Account)		142.20	 142.20

Ledger of M/s Uncertain Bank Ltd

Dr. Rebate on Bills Discounted Account Cr.

Date	Particulars	₹ in Cr.	Date	Particulars	₹ in Cr.
1998			1997		
March 31	To Interest and Discount A/c	9.00	April 1	By Balance b/d	9.00
"	To Balance c/d	10.80	1998		
			March 31	By Interest and Discount A/c (Rebate required)	10.80
		19.80			19.80

Dr. Interest and Discount Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1998			1998		
March 31	To Rebate on Bills Discounted A/c	10.80	March 31	By Rebate on Bills Discounted A/c	9.00
"	To Profit and Loss A/c (Transfer)	142.20	"	By Bills Discounted and Purchased A/c	144.00
		153.00			153.00

Working Notes :

(1) Calculation of Discount on Bills Discounted and Purchased

Discount = ₹ 4,000 crores × 18 / 100 × 73 / 365 = ₹ **144 crores**.

(2) Calculation of Rebate for Unexpired Period

Rebate = ₹ 600 crores × 18 / 100 × 36.5 / 365 = ₹ **10.80 crores**.

Illustration 8

Given below is an extract from the Trial Balance of T.K. Bank Limited as on 31st December, 2009 :

Particulars	Dr. (₹)	Cr. (₹)
Bills Discounted	12,64,000	
Rebate on Bills Discounted (1.1.2009)		8,340
Discount Received for the year		85,912

An analysis of the bills discounted is shown below :

Amount (₹)	Due Date in 2010	Rate of Discount (% p.a.)
1,40,000	March 6th	5
4,36,000	March 12th	4.5
2,82,000	March 26th	6
4,06,000	April 6th	4

Show the workings, how the relevant items will appear in the Bank's Profit and Loss Account as on 31st December, 2009 and in Bank's Balance Sheet as on 31st December, 2009. ***[C.A. (IPCC) — May, 2010]***

Solution

T.K. Bank Limited

Profit and Loss Account for the year ended 31st December, 2009

Particulars	Schedule No.	₹
I. Income :		
Interest Earned (Note 2)	13	80,978

Balance Sheet of T.K. Bank Limited as at 31st December, 2009

Particulars	₹
Other Liabilities and Provisions :	
Rebate on Bills Discounted (Note 1)	13,274

Working Notes : **(1) Calculation of Rebate on Bills Discounted**

Due Date of Bill	Days beyond 31.3.2009	Amount of the Bill (₹)	Rate of Discount p.a.	Amount of Discount (₹)
06.03.2010	65	1,40,000	5.00%	1,247
12.03.2010	71	4,36,000	4.50%	3,816
26.03.2010	85	2,82,000	6.00%	3,940
06.04.2010	96	4,06,000	4.00%	4,271
Total Rebate on Bills Discounted to be carried forward				13,274

Calculation of Days Beyond 31.12.2009

January		February		March		April		Total No. of Days
31	+	28	+	6	+	0	=	65
31	+	28	+	12	+	0	=	71
31	+	28	+	26	+	0	=	85
31	+	28	+	31	+	6	=	96

(2) Amount of Discount to be Credited to Profit and Loss Account

Particulars	₹
Discount received during the year	85,912
Add: Balance of Rebate on bills discounted on 1.1.2009	8,340
	94,252
Less: Rebate on bills discounted on 31.12.2009 (unexpired discount)	13,274
Amount transferred to Profit and Loss Account	80,978

Acceptance, Endorsement and Other Obligations

A bank is frequently called upon to accept or endorse a bill of exchange on behalf of its customer. For greater security, the drawer of the bill wants acceptance of the drawee's Bank. The Bank incurs a liability by accepting bills on behalf of its customers. On maturity of the bill, the bank pays and collects the amount from its customer. Generally, the bank requires the customer to deposit security equal to the sum of the bill accepted. The Bill accepted register is used for recording particulars of bills accepted and/or endorsed and securities provided.

At the end of the accounting period, if there is any outstanding bills, it is shown as 'Contingent Liability' as per the new format.

Illustration 9

From the following details prepare "Acceptances, Endorsements and other Obligations Account" as would appear in the general ledger.

On 1.4.1998 Acceptances not yet satisfied stood at ₹ 22,30,000. Out of which ₹ 20 lacs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register revealed the following:

Client	Acceptance / Guarantees (₹)	Remarks
A	10,00,000	Bank honoured on 10.6.1998
B	12,00,000	Party paid off on 30.9.1998
C	5,00,000	Party failed to pay and bank had to honour on 30.11.1998
D	8,00,000	Not satisfied up to 31.3.1999
E	5,00,000	-do-
F	2,70,000	-do-
Total	42,70,000	

[C.A. (Inter) — November, 1999]

Solution

As per new format, Acceptances, Endorsement and other Obligations are off Balance Sheet items. In the ***general ledger***, no account is maintained for this. The details are maintained on the memorandum basis. It has been asked in the question to show the relevant account in the general ledger which is not practical. However, it can be recorded elsewhere as follows :

Dr. **Acceptances, Endorsements and Other Obligations Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1998			1998		
?	To Constituents' Liabilities for Acceptance / Guarantees (paid by clients)	20,00,000	April 1	By Balance b/d	22,30,000
	To Constituents' Liabilities for Acceptance / Guarantees (paid by Bank)	2,30,000	June 10	By Constituents' Liabilities for Acceptance / Guarantees — A	10,00,000
June 10	To Constituents' Liabilities for Acceptance / Guarantees (paid by Bank)	10,00,000	Sept. 30	By Constituents' Liabilities for Acceptance / Guarantees — B	12,00,000
Sept. 30	To Constituents' Liabilities for Acceptance / Guarantees (paid by Party)	12,00,000	Nov. 30	By Constituents' Liabilities for Acceptance / Guarantees — C	5,00,000
	To Constituents' Liabilities for Acceptance / Guarantees (paid by Bank)	5,00,000	1999 March 31	By Constituents' Liabilities for Acceptance / Guarantees — D	8,00,000
				E	5,00,000
1999 March 31	To Balance c/d	15,70,000		F	2,70,000
		65,00,000			65,00,000

RBI's Prudential Norms Relating to Advances

Introduction

As a regulatory authority, RBI is issuing from time to time various guidelines to the banks for proper administration of loans and advances. In 1980, the RBI introduced 'Health Code' system for classifying bank's loan assets. Under this code system, bank's loan assets were being classified into 8 categories. These were :

HC - 1 → 'Satisfactory'.
HC - 2 → 'Irregular'
HC - 3 → 'Sick but Viable'
HC - 4 → 'Sick but non-Viable'
HC - 5 → 'Recalled'
HC - 6 → 'Suit-filed'
HC - 7 → 'Decreed'
HC - 8 → 'Bad and Doubtful'

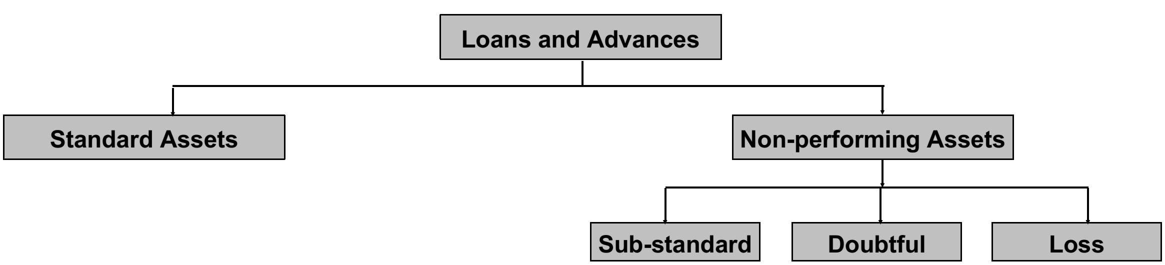
Many banks were recognising interest as income on accrual basis even on those loan assets, which had shown bad symptoms. It was not a good business practice because banks paid income tax and dividends on these income, which were never realised.

On the basis of recommendations of Narasimhan Committee, RBI laid down norms which is known as ***Prudential Accounting Norms*** and implemented in a phased manner on a three-year period commencing from 1st April, 1992. In 1998, the Narasimhan Committee had submitted its 2nd report for further tightening the Prudential Accounting Norms. The prudential accounting norms consist of the following ***three*** norms :

(a) Assets Classification
(b) Income Recognition
(c) Provisioning

(a) Assets Classification

Bank's loans and advances are to be classified into two broad categories — Standard and Non-Performing. Non-performing assets (NPA) are sub-divided into — Sub-standard; Doubtful and Loss assets.



Definitions

Standard Assets: Standard Asset is one which does not disclose any problem and which does not carry more than normal risk attached to the business. Such an asset should not be an NPA.

Sub-Standard Assets : With effect from 31 March, 2005 a sub-standard asset would be one, ***which has remained NPA for a period less than or equal to 12 months***. In such cases, the current net worth of the borrower / guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

Doubtful Assets : With effect from March 31, 2005, an asset would be classified as doubtful, if it has ***remained in the sub-standard category for a period of 12 months***. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

Loss Assets : A loss asset is one where loss has been identified by the bank or internal or external auditors or the Reserve Bank of India inspectors but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

Source : RBI Master Circular (www.rbi.org).

Identification of Non-Performing Assets (NPA)*

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the banks.

A non-performing asset (NPA) is loan or an advance where :

(i) Interest and/or instalment of principal remain ***overdue*** for a period of more than 90 days in respect of a Term Loan.

(ii) The account remains '***Out of order***' as indicated below, in respect of an Overdraft/Cash Credit (OD/CC).

(iii) The bill remains ***overdue*** for a period of more than 90 days, in the case of bills purchased and discounted.

(iv) The instalment of principal or interest thereon remains ***overdue*** for twe crop seasons for short duration crops.

(v) The instalment of principal or interest thereon remains ***overdue*** for one crop season for long duration crops.

(vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

(vii) In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

'Out of Order' Status : An account should be treated as ***out of order*** if the outstanding balance remains continuously in excess of the sanctioned limit / drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit / drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as ***out of order***.

Overdue : Any amount due to the bank under any credit facility is ***overdue*** if it is not paid on the due date fixed by the bank.

*Source : RBI Master Circular No. RBI/2015-16/39

Agricultural Advances

(i) A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each state. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

(ii) Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period, and the sanctioning of fresh short-term loan, subject to guidelines contained in RBI Circular RPCD. No. PLFS.BC.8/05.04.02/2011-12 dated July 1, 2011.

(iii) In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not 'long duration' would be treated as "short duration" crops.

(iv) While fixing the repayment schedule in case of rural housing advances granted to agriculturists under Indira Awas Yojana and Golden Jubilee rural Housing Finance Scheme, banks should ensure that the interest / instalment payable on such advances are linked to crop cycles.

Government Guaranteed Advances

The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPA ***is not for the purpose of recognition of income***. The requirement of invocation of guarantee has been delinked for deciding the asset classification and provisioning requirements in respect of State Government guaranteed exposures. With effect from the year ending 31 March 2006 State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days.

Identification of Assets as NPAs should be done on an ongoing basis

The system should ensure that identification of NPAs is done on an on-going basis and doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per prescribed norms. Banks should also make provisions for NPAs as at the end of each calendar quarter, i.e., as at the end of March/June/September/December, so that the Income and Expenditure Account for the respective quarters as well as the Profit and Loss Account and Balance Sheet for the year end reflects the provision made for NPAs.

Guidelines for Identification of NPA at a Glance

Type of Credit Facility	NPA Criteria
1. Term Loan	The interest and/or installment of principal remain ***'overdue'*** for a period of more than 90 days.
2. Cash Credit and Overdraft	The account remains ***'out of order'*** for a period of more than 90 days.
3. Bills Purchased and Discounted	The bill remain '***overdue***' for a period more than 90 days.
4. All Direct Agricultural Advances	**(i) Short duration crops :** The installment of principal or interest thereon remains '***overdue***' for two crop seasons. **(ii) Long duration crops :** The installment of principal or interest thereon remains '***overdue***' for one crop season.
5. Other Loan Accounts	Any amount to be received remains ***'overdue'*** for a period of ***more than 90 days***.

Illustration 10

The following two term loan accounts were sanctioned by UBI Main Branch, Kolkata on 1st January, 2016. The details are given below :

Particulars		Loan A/c (A & Co.)	Loan A/c (B & Co.)
(i) Amount of loan	₹	6,00,000	10,00,000
(ii) Period		5 years	5 years
(iii) Basis of Installment		Quarterly	Half yearly
(iv) Rate of Interest	(%)	12	12
(v) Amount of Installments	₹	30,000 + Interest	1,00,000 + Interest

You are required to find out the date on which these accounts will become NPA. Assume that there is no recovery.

Solution **Calculation of Date of NPA**

Particulars	Loan A/c A & Co.	Loan A/c B & Co.
Date of Loan	1.1.2016	1.1.2016
Basis of Installment	Quarterly	Half yearly
Due Date for 1st Installment	31.3.2016	30.6.2016
Overdue Starts	1.4.2016	1.7.2016
Date of NPA Symptom (Exact date of NPA > 90 days)	29.6.2016	28.9.2016

Illustration 11

The following information is available in respect of three bills discounted by Bank of India, Gol Market Branch, Delhi.

Particulars		X-Bill	Y-Bill	Z-Bill
Amount of the Bill	₹	1,00,000	1,50,000	2,00,000
Date of Discount of the Bill		1.9.2015	1.9.2015	1.9.2015
Due Date of the Bill		1.10.2015	1.11.2015	1.2.2016

If the above three bills remain unpaid, find out the date when they would be declared NPA. Also mention the Balance Sheet date for NPA declaration.

Solution **Calculation of Date of NPA**

Particulars	X-Bill	Y-Bill	Z-Bill
Date of Discounting of the Bill	1.9.2015	1.9.2015	1.9.2015
Due Date of the Bill	1.10.2015	1.11.2015	1.2.2016
Date of NPA Symptom (Exact date of NPA > 90 days)	29.12.2015	29.1.2016	1.5.2016
Balance Sheet Date for NPA Declaration	31.3.2016	31.3.2016	31.3.2014

(b) Income Recognition

The policy of income recognition has to be objective and based on the record of recovery. The banks should follow the following policy for recognition of income.

1. The income from non-performing assets (NPA) is ***not*** recognised on ***accrual*** basis but is booked as ***income*** only when it is ***actually received***. Therefore, banks should not charge and take to Income Account interest on all non-performing assets.
2. However, interest on 'Standard Assets', i.e., performing assets is to be recognised on ***accrual*** basis.
3. Interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to Income Account on the due date, provided adequate margin is available in the accounts.
4. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.
5. If Government guaranteed advances become 'overdue' and thereby NPA, the interest on such advances should not be taken to Income Account unless the interest has been realised. The exemption, if any, is granted only for the purpose of asset classification.

Illustration 12

Following are the statements of interest on advances in respect of performing and non-performing assets of Madura Bank Ltd Find out the income to be recognised for the year ended 31st March, 1998. [all figures in ₹ lakhs]

	Interest earned	Interest received
Performing Assets		
Cash credit and overdrafts	1,800	1,060
Term loan	480	320
Bills purchased and discounted	700	550
Non-performing Assets		
Cash credit and overdrafts	450	70
Term Loan	300	40
Bills purchased and discounted	350	36

[C.A. (Inter) — November, 1998]

Solution

As per RBI's 'Prudential Norms', interest on performing assets should be recognised as income on ***accrual basis***. However, interest on non-performing assets should not be recognised as income unless the same has been ***realised***.

Calculation of Income to be Recognised

Particulars	(₹ in Lakhs)	(₹ in Lakhs)
1. Interest on Cash Credit and Overdraft		
— Performing assets (earned)	1,800	
— Non-performing assets (received)	70	1,870
2. Interest on Term Loan		
— Performing assets (earned)	480	
— Non-performing assets (received)	40	520
3. Bills Purchased and Discounted		
— Performing assets (earned)	700	
— Non-performing assets (received)	36	736
Total Income to be Recognised		3,126

Illustration 13

Given below are details of interest on advances of a commercial Bank as on 31st March, 2016 [all figures in ₹ lakhs]:

	Interest earned	Interest received
Performing Assets		
Term loan	240	160
Cash credit and overdraft	1,500	1,240
Bills purchased and discounted	300	300
Non-performing Assets		
Term Loan	150	10
Cash credit and overdrafts	300	24
Bills purchased and discounted	200	40

Find out the income to be recognised for the year ended 31st March, 2016. ***[I.C.W.A. (Final) — Adapted]***

Solution

As per RBI's 'Prudential Norms', interest on performing assets should be recognised as income on ***accrual basis***. However, interest on non-performing assets should not be recognised as income unless the same has been ***realised***.

Calculation of Income to be Recognised

Particulars	(₹ in Lakhs)	(₹ in Lakhs)
1. Interest on Term Loan		
— Performing assets (earned)	240	
— Non-performing assets (received)	10	250
2. Interest on Cash Credit and Overdraft		
— Performing assets (earned)	1,500	
— Non-performing assets (received)	24	1,524

3. Bills Purchased and Discounted		
— Performing assets (earned)	300	
— Non-performing assets (received)	40	340
Total Income to be Recognised		2,114

(c) Provisioning of Loans and Advances

In conformity with the prudential norms, provisions should be made on the non-performing assets on the ***basis of classification of assets*** (***discussed in page 13.29 and 13.30***).

The banks should make provision against loss assets, doubtful assets, sub-standard assets and standard assets as follows :

Loss Assets

The entire assets should be written-off after obtaining necessary approval from the competent authority. If the assets are permitted to remain in the books for any reason, ***100% of the outstanding should be provided for***.

Doubtful Assets

100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has remained in 'doubtful' category	**Provision requirement (%)**
Up to one year	25
One to three years	40
More than three years	100

Note: Valuation of Security for provisioning purposes

With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of ₹ 5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

Sub-standard Assets

(i) A general provision of 15 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and ***securities available***.

(ii) The 'unsecured exposures' which are identified as 'sub-standard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance. However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows. The provisioning requirement for unsecured 'doubtful' assets is 100 per cent. Unsecured exposure is defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank's inspecting officers, is not more than 10 percent, ***ab-initio***, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State Government guarantees), comfort letters etc.

(iii) In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, it is advised that the following would be applicable from the financial year 2009-10 onwards :

a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.

b) However, banks may treat annuities under build-operate-transfer (BOT) model in respect of road / highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

c) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

Standard Assets

(i) The provisioning requirements for all types of standard assets stands as below. Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:

(a) direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;

(b) advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;

(c) housing loans extended at teaser rates and restructured advances.

(d) all other loans and advances not included in (a) (b) and (c) above at 0.40 per cent

(ii) The provisions on standard assets should not be reckoned for arriving at net NPAs.

(iii) The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions -Others' in Schedule 5 of the balance sheet.

(iv) It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular RPCD.SME&NFS.BC.No. 9/06.02.31/2011-12 dated July 1, 2011 on Lending to Micro, Small & Medium Enterprises (MSME) Sector.

Illustration 14

From the following information of details of advances of Zenith Bank Ltd, calculate the amount of provisions to be made in Profit and Loss Account for the year ended 31.3.2010 :

Asset Classification	₹ in Lakhs
Standard	10,000
Sub-standard	6,400
Doubtful :	
for one year	3,200
for two years	1,800
for three years	900
for more than three years	1,100
Loss assets	3,000

[C.A. (IPCC) — November, 2010]

Solution **Calculation of Required Provisions**

Assets Classification	Amount (₹ in Lakhs)	% of Provision	Provisions (₹ in Lakhs)
Standard	10,000	0.40	40
Sub-standard	6,400	15	960
Doubtful :			
for one year	3,200	25	800
for two years	1,800	40	720
for three years	900	40	360
for more than three years	1,100	100	1,100
Loss assets	3,000	100	3,000
Total Provisions			6,980

Illustration 15

From the following information of details of advances of X Bank Limited calculate the amount of provisions to be made in Profit and Loss Account for the year ended 31.3.2007 :

Assets Classification	₹ in Lakhs
Standard	6,000
Sub-standard	4,400
Doubtful :	
For one year	1,800
For two years	1,200
For three years	800
For more than three years	600
Loss assets	1,600

[C.A. (PE-II) — May, 2007]

Solution **Calculation of Required Provisions**

Type of Assets	Amount (₹ in Lakhs)	% of Provision	Required Provision (₹ in Lakhs)
Standard	6,000	0.40	24
Sub-standard (Note 1)	4,400	15.00	660
Doubtful :			
One year (Note 1)	1,800	25.00	450
Two years (Note 1)	1,200	40.00	480
Three years (Note 1)	800	40.00	320
More than three years	600	100.00	600
Loss assets	1,600	100.00	1,600
			4,134

Working Note (1) : It is assumed that doubtful assets are fully secured. If it is unsecured then 100% provision is to be made.

Illustration 16

From the following information, compute the amount of provisions to be made in the Profit and Loss Account of a commercial bank.

Assets	₹ in Lakhs
(i) Standard (Value of security ₹ 6,000 lakhs)	7,000
(ii) Sub-standard	3,000
(iii) Doubtful :	
(a) Doubtful for less than one year (Realisable value of security ₹ 500 lakhs)	1,000
(b) Doubtful for more than one year, but less than 3 years (Realisable value of security ₹ 300 lakhs)	500
(c) Doubtful for more than 3 years (No security)	300

[C.A. (PE-II) — May, 2006]

Solution **Calculation of Required Provisions**

Type of Assets	Amount (₹ in Lakhs)	% of Provision	Required Provision (₹ in Lakhs)
Standard	7,000	0.40	28
Sub-standard	3,000	15.00	450
(a) Doubtful (less than one year)			
— On secured portion	500	25.00	125
— On unsecured portion	500	100.00	500
(b) Doubtful (more than one year but less than 3 years)			
— On secured portion	300	40.00	120
— On unsecured portion	200	100.00	200
(c) Doubtful (more than 3 years)			
— On unsecured portion	300	100.00	300
			1,723

Illustration 17

From the following details, compute the amount of provision required to be made in the Profit and Loss Account of Evergreen Bank Ltd for the year 2015-16 :

Assets	(₹ in Lakhs)
Standard	16,000
Sub-standard	12,000
Doubtful :	
— One year (secured)	4,800
— For two to three years (secured)	3,600
— For more than three years (secured by mortgage of machinery worth ₹ 1,000 lakhs)	1,800
Non-recoverable assets	3,000

[C.S. (Inter) — Adapted]

Solution **Calculation of Required Provision**

Types of Assets	Amount (₹ in Lakhs)	% of Provision	Required Provision (₹ in Lakhs)
Standard	16,000	0.40	64
Sub-standard	12,000	15.00	1,800
Doubtful — one year (secured)	4,800	25.00	1,200
— for two to three years (secured)	3,600	40.00	1,440
— for more than three years (secured)	1,000	100.00	1,000
— for more than three years (unsecured)	800	100.00	800
Non-recoverable assets	3,000	100.00	3,000
Total Provision Required			9,304

Advances Covered by ECGC Guarantee

In case of advances guaranteed by Export Credit Guarantee Corporation (ECGC), the provision should be made only for the balance in excess of the amount guaranteed by these corporations. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these corporations.

Illustration 18

A loan account remains out of order as on the date of Balance Sheet of a Bank. The account has been classified as doubtful assets (upto 1 year).

Details of the accounts are :

Outstanding — ₹ 6,73,000;

ECGC coverage — 25% (Limited to ₹ 1,00,000);

Value of security held — ₹ 1,50,000.

Compute the necessary provision to be made by the Bank as per applicable rates.

[C.A. (IPCC) — November, 2015]

Solution **Calculation of Provision Required to be Made**

Particulars	₹
Balance Outstanding	6,73,000
Less: Value of Security Held (assumed to be realised in full)	1,50,000
Unrealised balance	5,23,000
Less: ECGC Coverage (maximum limit)	1,00,000
Unsecured Balance	4,23,000
Required Provision :	
100% on unsecured balance	4,23,000
25% on secured portion (25% of ₹ 1,50,000)	37,500
Total Provision Required	4,60,500

Illustration 19

From the following information find out the amount of provisions required to be made in the Profit and Loss Account of a commercial bank for the year ended 31st March, 2016:

(i) Packing credit outstanding from Food Processors ₹ 60 lakhs against which the bank holds securities worth ₹ 15 lakhs. 40% of the above advance is covered by ECGC. The above advance has remained doubtful for more than 3 years.

(ii) Other advances:

Asset classification	(₹ in Lakhs)
Standard	3,000
Sub-standard	2,200
Doubtful :	
For one year	900
For two years	600
For three years	400
For more than 3 years	300
Loss assets	600

[C.A. (PE-II) — Adapted]

Solution

(i) Calculation of Required Provision on Packing Credit

Particulars	₹ in Lakhs
Packing Credit Outstanding	60
Less: Value of Security Held	15
Unrealised Balance	45
Less: ECGC Coverage (40% of ₹ 60 lakhs)	24
Unsecured balance	21
Required Provision :	
100% on unsecured balance (100% of ₹ 21 lakhs)	21
100% on secured portion (as it is doubtful for more than 3 years)	15
	36

Alternative Solution

(i) Calculation of Required Provision on Packing Credit

Particulars	(₹ in Lakhs)
Balance outstanding on 31.3.2016	60.00
Less: Realisable value of securities (assumed to be realised in full)	15.00
Unsecured balance	45.00
Required Provision :	
@ 100% for unsecured portion	45.00
@ 100% for secured portion (Doubtful for more than 3 years)*	15.00
	60.00
Less: ECGC cover @ 40%	24.00
Total Provision Required	36.00

(ii) Calculation of Required Provision on Other Advances

Types of Assets	Amount (₹ in Lakhs)	% of Provision	Reqd. Provision (₹ in Lakhs)
Standard	3,000	0.40	12
Sub-standard	2,200	15.00	330.00
Doubtful — for one year*	900	25.00	225.00
— for two years*	600	40.00	240.00
— for three years*	400	40.00	160.00
— for more than three years* (Note 2)	300	100.00	300.00
Loss Assets	600	100.00	600.00
Total Provision Required on Other Advances			1,867.00

* It is assumed that doubful assets are all fully secured.

Total provision required : ₹ 36 + ₹ 1,867 Lakhs = ₹ 1,903 Lakhs.

Illustration 20

Rajatapeeta Bank Ltd had extended the following credit lines to a small-scale Industry, which had not paid any interest since March, 2009 [all figures in ₹ lakhs] :

	Term Loan	Export Credit
Balance Outstanding on 31.3.2016	35	30
ECGC Cover	40%	50%
Securities held	15	10
Realisable value of securities	10	8

Compute necessary provisions to be made for the year ended 31st March, 2016.

[C.A. (PE-II) — Adapted]

Solution **Calculation of Required Provisions**

Particulars	Term Loan		Export Credit	
	(₹ in Lakhs)	(₹ in Lakhs)	(₹ in Lakhs)	(₹ in Lakhs)
Balance outstanding on 31.3.2016		35.00		30.00
Less: Realisable value of securities		10.00		8.00
		25.00		22.00
Less: ECGC cover @ 40%		10.00		—
ECGC cover @ 50%		—		11.00
Unsecured Balance		15.00		11.00
Required Provision :				
100% for unsecured portion		15.00		11.00
Add: 100% of secured portion (Doubtful for more than 3 years)	10		8	
Less: ECGC cover @ 40%	4	6.00	—	
ECGC cover @ 50%			4	4.00
Total Provision Required		21.00		15.00

Alternatively, **Calculation of Required Provisions**

Particulars	Term Loan (₹ in Lakhs)	Export Credit (₹ in Lakhs)
Balance outstanding on 31.3.2016	35.00	30.00
Less: Realisable value of security	10.00	8.00
Unsecured Balance	25.00	22.00
Required Provision :		
100% for unsecured portion	25.00	22.00
Add: 100% for secured portion (Doubtful for more than 3 years)	10.00	8.00
	35.00	30.00
Less: ECGC cover @ 40%	14.00	—
ECGC cover @ 50%	—	15.00
Total Provision Required	21.00	15.00

Guidelines for Provisions Under Special Circumstances

Advances granted under rehabilitation packages approved by BIFR/term lending institutions :

(i) In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset.

(ii) As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.

(iii) In respect of additional credit facilities granted to SSI units which are identified as sick [as defined in Section IV (Para 4.6) of circular RPCD.SME&NFS.BC.No.9/06.02.31/2011-12 dated 1 July 2011] and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provision need be made for a period of one year.

Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, gold ornaments, government & other securities and life insurance policies would attract provisioning requirements as applicable to their asset classification status

Treatment of Interest Suspense Account

Amounts held in Interest Suspense Account should not be reckoned as part of provisions. Amounts lying in the Interest Suspense Account should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

Preparation of Profit and Loss Account

Illustration 21

From the following information, you are required to prepare Profit and Loss Account of Zee Bank Ltd, for the year ending 31st March, 2009 :

Particulars	₹	Particulars	₹
Interest and Discount	44,00,000	Interest Expended	13,60,000
Other Income	1,25,000	Operating Expenses	13,31,000
Income on Investments	5,000	Interest on Balance with RBI	25,000

Additional information :

(a) Rebate on bills discounted to be provided for ₹ 15,000.

(b) Classification of advances :

Particulars	₹
Standard assets	25,00,000
Sub-standard assets	5,60,000
Doubtful assets not covered by security	2,55,000
Doubtful assets covered by security	
for 1 year	25,000
for 2 years	50,000
for 3 years	1,00,000
for 4 years	75,000
Loss assets	1,00,000

(c) Make tax provision @ 35%.

(d) Profit and Loss Account (Cr.) ₹ 40,000. ***[C.A. (IPCC) — November, 2009]***

Solution

Zee Bank Ltd

Profit and Loss Account for the year ended 31st March, 2009

	Schedule No.	Year ended 31.3.2009 (Current Year)
I. **Income**		₹
Interest earned	13	44,15,000
Other income	14	1,25,000
Total		45,40,000
II. **Expenditure**		
Interest expended	15	13,60,000
Operating expenses	16	13,31,000
Provisions and contingencies (Note 3)		10,30,813
Total		37,21,813
III. **Profit / Loss**		
Net Profit / Loss (–) for the year (I – II)		8,18,187
Profit / Loss (–) brought forward		40,000
Total		8,58,187
IV. **Appropriations**		
Transfer to statutory reserves (25% of Net Profit)		2,04,547
Balance carried over to Balance Sheet		6,53,640
Total		8,58,187

Schedule 13 : Interest Earned	₹	**Schedule 15 : Interest Expended**	₹
Interest and Discount received (Note 4)	43,85,000	I. Interest on Deposits	13,60,000
Income on Investments	5,000	II. Interest on RBI / Inter-bank borrowings	—
Interest on balances with RBI	25,000	III. Others	—
Total	44,15,000		13,60,000

Working Notes : **(1) Calculation of Provisions Required**

Assets Classification	Amount (₹)	% of Provision	Provision ₹
Standard assets	25,00,000	0.40	10,000
Sub-standard assets (assumed fully secured)	5,60,000	15	84,000
Doubtful assets not covered by security	2,55,000	100	2,55,000
Doubtful assets covered by security :			
for 1 year	25,000	25	6,250
for 2 years	50,000	40	20,000
for 3 years	1,00,000	40	40,000
for 4 years	75,000	100	75,000
for more than 4 years	1,00,000	100	1,00,000
			5,90,250

(2) Calculation of Provision for Tax

Particulars			₹
Income			45,40,000
Less: Expenditure :			
Interest Expense	13,60,000		
Operating Expense		13,31,000	26,91,000
			18,49,000
Less: Provision on NPA			5,90,250
			12,58,750
Tax @ 35% on ₹ 12,58,750 = ₹ **4,40,563** (rounded off)			

(3) Total Amount of Provisions and Contingencies

Particulars	₹
(i) Provision on NPA (Note 1)	5,90,250
(ii) Provision for tax (Note 2)	4,40,563
	10,30,813

(4) Interest and Discount

Particulars	₹
Interest and Discount Received	44,00,000
Less: Rebate on Bills Discounted	15,000
	43,85,000

Illustration 22

The following figures are extracted from the books of KLM Bank Ltd as on 31.3.2012 :

Particulars	₹
Interest and Discount Received	38,00,160
Interest Paid on Deposits	22,95,360
Issued and Subscribed Capital	10,00,000
Salaries and Allowances	2,50,000
Directors Fees and Allowances	35,000
Rent and Taxes Paid	1,00,000
Postage and Telegrams	65,340
Statutory Reserve Fund	8,00,000
Commission, Exchange and Brokerage	1,90,000
Rent Received	72,000
Profit on Sale of Investment	2,25,800
Depreciation on assets	40,000
Statutory Expenses	38,000
Preliminary Expenses	30,000
Auditor's Fee	12,000

The following further information is given :

(1) A customer to whom a sum of ₹ 10 lakhs was advanced has become insolvent and it is expected only 55% can be recovered from his estate.

(2) There was also other debts for which a provision of ₹ 2,00,000 was found necessary.

(3) Rebate on Bills Discounted on 31.3.2011 was ₹ 15,000 and on 31.3.2015 was ₹ 20,000.

(4) Income tax of ₹ 2,00,000 is to be provided.

The directors desire to declare 5% dividend.

Prepare the Profit and Loss Account of KLM Bank Ltd for the year ended 31.3.2012 and also show, how the Profit and Loss Account will appear in the Balance Sheet if the Profit and Loss Account opening balance was Nil as on 31.3.2011.

[C.A. (IPCC) — November, 2012]

Solution

KLM Bank Limited
Profit and Loss Account for the year ended 31st March, 2015

	Schedule No.	Year ended 31.3.2012 (Current Year)
I. **Income**		₹
Interest earned	13	37,95,160
Other income	14	4,87,800
Total		42,82,960
II. **Expenditure**		
Interest expended	15	22,95,360
Operating expenses	16	5,70,340
Provisions and contingencies (Note 2)		8,50,000
Total		37,15,700
III. **Profit / Loss**		
Net Profit / Loss (–) for the year		5,67,260
Profit / Loss (–) brought forward		—
Total		5,67,260
IV. **Appropriations**		
Transfer to statutory reserves (25% of ₹ 5,67,260)		1,41,815
Transfer to other reserves		—
Proposed Dividend (5% of ₹ 10,00,000)		50,000
Corporate Dividend Tax @ 17% (Note 3)		8,500
Balance carried over to Balance Sheet		3,66,945
Total		5,67,260

In the Balance Sheet, Profit and Loss Account balance of ₹ 3,66,945 will appear under 'Reserve and Surplus' — Schedule 2.

SCHEDULE 13 — INTEREST EARNED

		Year ended 31.3.2012 (Current Year)
I.	Interest/discount on advances / bills (Note 1)	37,95,160
II.	Income on investments	—
III.	Interest on balances with Reserve Bank of India and other inter-bank funds	—
IV.	Others	—
	Total	37,95,160

SCHEDULE 14 — OTHER INCOME

		Year ended 31.3.2012 (Current Year)
I.	Commission, exchange and brokerage	1,90,000
II.	Profit on sale of investments	2,25,800
III.	Rent Received	72,000
	Total	4,87,800

SCHEDULE 15 — INTEREST EXPENDED

		Year ended 31.3.2012 (Current Year)
I.	Interest on deposits	22,95,360
II.	Interest on Reserve Bank of India / inter-bank borrowings	—
III.	Others	—
	Total	22,95,360

SCHEDULE 16 — OPERATING EXPENSES

		Year ended 31.3.2012 (Current Year)
I.	Payments to and provisions for employees	2,50,000
II.	Rent, taxes and lighting	1,00,000
III.	Printing and stationery	—
IV.	Advertisement and publicity	—
V.	Depreciation on bank's property	40,000
VI.	Directors' fees, allowances and expenses	35,000
VII.	Auditors' fees and expenses (including branch auditors' fees and expenses)	12,000
VIII.	Law charges (Statutory charges)	38,000
IX.	Postages, telegrams, telephones, etc.	65,340
X.	Repairs and maintenance	—
XI.	Insurance	—
XII.	Other expenditure (Preliminary expenses)	30,000
	Total	5,70,340

Working Notes : **(1) Interest and Discount**

Particulars	₹
Interest and Discount Received	38,00,160
Add: Rebate on Bills Discounted on 31.3.2011	15,000
	38,15,160
Less: Rebate on Bills Discounted on 31.3.2015	20,000
	37,95,160

(2) Provisions and Contingencies

Particulars	₹
Provision for bad debts (specific) — 45% of ₹ 10,00,000	4,50,000
Provision for bad debts (general)	2,00,000
Income tax	2,00,000
	8,50,000

(3) Corporate dividend tax is payable when dividend is proposed or paid. Corporate dividend is to be paid by the bank and it should be treated as an appropriation of profit.

Illustration 23

The following are the figures extracted from the books of Sukalyan Bank Ltd as on 31.3.2016.

(all figures in ₹)

Interest and Discount received	20,30,000	Directors' fees and allowances	12,000
Interest paid on Deposits	12,02,000	Rent and taxes paid	54,000
Issued and Subscribed Capital	5,00,000	Stationery and printing	12,000
Reserve under Section 17	3,50,000	Postage and Telegram	25,000
Commission, Exchange and Brokerage	90,000	Other expenses	12,000
Rent received	30,000	Audit fees	4,000
Profit on sale of investment	95,000	Depreciation on Bank's properties	12,500
Salaries and Allowances	1,05,000		

Other information :

(i) Provision for bad and doubtful debts necessary ₹ 2,00,000.

(ii) Rebate on bills discounted as on 31.3.2016, ₹ 7,500.

(iii) Provide ₹ 3,50,000 for income tax.

(iv) The directors desire to declare 10% dividend.

Make the necessary assumptions and prepare the Profit and Loss Account in accordance with the law.

Solution

Sukalyan Bank Ltd
Profit and Loss Account for the year ended 31st March, 2016

	Schedule No.	Year ended 31.3.2016 (Current Year)
I. **Income**		₹
Interest earned	13	20,22,500
Other income	14	2,15,000
Total		22,37,500
II. **Expenditure**		
Interest expended	15	12,02,000
Operating expenses	16	2,36,500
Provisions and contingencies (Note 1)		5,50,000
Total		19,88,500
III. **Profit / Loss**		
Net Profit / Loss (–) for the year		2,49,000
Profit / Loss (–) brought forward		—
Total		2,49,000
IV. **Appropriations**		
Transfer to statutory reserves (25% of Net Profit) (Note 3)		62,250
Transfer to other reserves		—
Proposed dividend (10% of ₹ 5,00,000) (Note 4)		50,000
Corporate Dividend Tax @ 17%		8,500
Balance carried over to Balance Sheet		1,28,250
Total		2,49,000

Working Notes : **(1) Calculation of Provisions and Contingencies**

	₹
Provision for doubtful debts :	2,00,000
Provision for Income tax	3,50,000
	5,50,000

(2) It is assumed that Rebate on Bill Discounted as on 31.3.2015 was nil.

(3) As per the provision of section 17 of the Banking Regulation Act, 1949 amount to be transferred to Statutory Reserve should not be less than 20% of Net Profit. But as a further prudent measure, banks have been asked to transfer 25% of Net Profit. Here, **25% of Net Profit** has been transferred to Statutory Reserve.

(4) It is assumed that the dividend has been proposed as per RBI guidelines.

(5) Corporate Dividend tax is payable when dividend is proposed / paid.

Schedule 13 : Interest Earned		₹
I. Interest and Discount received	20,30,000	
Less : Rebate on bill discounted	7,500	20,22,500
II. Income on Investments		
III. Interest on balances with RBI and other inter-bank fund		
IV. Others		
Total		20,22,500

Schedule 14 : Other Income	₹
I. Commission, exchange and brokerage	90,000
II. Rent received	30,000
III. Net Profit on sale of investments	95,000
IV. Net Profit on revaluation of investments	—
Less : Net Loss on revaluation of investments	—
V. Net Profit on sale of land, buildings & other assets	—

Schedule 15 : Interest Expended	₹
I. Interest on Deposits	12,02,000
II. Interest on RBI / Inter-bank borrowings	—
III. Others	—
Total	12,02,000

Schedule 16 : Operating Expenses	₹
I. Payment to and provision for employees	1,05,000
II. Rent, taxes and lighting	54,000
III. Printing and stationery	12,000
IV. Advertisement and publicity	—
V. Depreciation on Bank's property	12,500
VI. Directors' fees and allowances	12,000
VII. Auditor's fees and expenses	4,000
VIII. Law charges	—

VI. Net Profit on exchange transactions	—	IX. Postage and telegram	25,000
VII. Income earned by way of dividends etc from subsidiaries/ joint ventures setup abroad / in India	—	X. Repairs and maintenance	—
		XI. Insurance	—
VIII. Miscellaneous Income	—	XII. Other expenditure	12,000
Total	2,15,000	**Total**	2,36,500

Illustration 24

From the following information, prepare the Profit and Loss Account of ABC Bank Ltd, for the year ended on 31st March, 2016. (all figures in ₹)

Interest on loan	2,59,000	Rent and taxes	18,000
Interest on fixed deposits	2,75,000	Interest on overdraft	1,54,000
Rebate on bills discounted required	49,000	Directors' fees	3,000
Commission	8,200	Auditors' fees	1,200
Establishment	54,000	Interest on savings bank deposit	68,000
Discount on bills discounted (Net)	1,95,000	Postage and telegrams	1,400
Interest on cash credit	2,23,000	Printing and stationery	2,900
Interest on Current Account	42,000	Sundry expenses	1,700

Bad debts to be written-off amounted to ₹ 40,000. Provision for taxation may be made @ 55 per cent. Balance of Profit from last year was ₹ 1,20,000. Transfer 25% of Profits to statutory reserve and provide ₹ 20,000 for dividends.

[C.A. (Inter) — Adapted]

Solution

ABC Bank Ltd
Profit and Loss Account for the year ended 31st March, 2016

	Schedule No.	Year ended 31.3.2016 (Current Year)
I. **Income**		₹
Interest earned	13	7,82,000
Other income	14	8,200
Total		7,90,200
II. **Expenditure**		
Interest expended	15	3,85,000
Operating expenses	16	82,200
Provisions and contingencies (Note 1)		1,95,650
Total		6,62,850
III. **Profit / Loss**		
Net Profit / Loss (–) for the year (I – II)		1,27,350
Profit / Loss (–) brought forward		1,20,000
Total		2,47,350
IV. **Appropriations**		
Transfer to statutory reserves (Note 2)		31,838
Transfer to other reserves		Nil
Proposed dividend		20,000
Corporate Dividend Tax @ 17%		3,400
Balance carried over to Balance Sheet		1,92,232
Total		2,47,470

Working Notes : **(1) Provisions and Contingencies**

		₹
Bad Debts	40,000	
Provision for taxation : 55% of ₹ 2,83,000 (₹ 7,90,200 – ₹ 3,85,000 – ₹ 82,200 – ₹ 40,000)	1,55,650	1,95,650

(2) Amount to be transferred to Statutory Reserve = 25% of ₹ 1,27,350 = ₹ 31,838.
(3) It is assumed that the dividend has been proposed as per RBI guidelines.
(5) Corporate Dividend tax is payable when dividend is proposed / paid.

Schedule 13 : Interest Earned		₹
Interest		
On Loan	2,59,000	
On Cash credit	2,23,000	
On Overdraft	1,54,000	6,36,000
Discount	1,95,000	
Less: Rebate on bill discounted required	49,000	1,46,000
Total		7,82,000

Schedule 14 : Other Income	₹
Commission	8,200

Schedule 15 : Interest Expended			₹
Interest on Deposit :	Fixed Deposit	2,75,000	
	Current Account	42,000	
	S/B Deposit	68,000	3,85,000

Schedule 16 : Operating Expenses	₹
I. Payment to and provision for employees : Establishment	54,000
II. Rent and taxes	18,000
III. Printing and stationery	2,900
IV. Advertisement and publicity	Nil
V. Depreciation on Bank's property	Nil
VI. Directors' fees and allowances	3,000
VII. Auditor's fees and expenses	1,200
VIII. Law charges	Nil
IX. Postage and telegrams	1,400
X. Repairs and maintenance	Nil
XI. Insurance	Nil
XII. Other Expenditure	1,700
Total	82,200

Illustration 25

The following are the figures extracted from the books of New Era Bank Limited, as on 31.3.2016 : (figures in ₹)

Interest and Discount received	37,05,738	Commission, exchange and brokerage	1,90,000
Interest paid on Deposits	20,37,452	Rent received	65,000
Issued and Subscribed Capital	10,00,000	Profit on sale of investments	2,00,000
Salaries and Allowances	2,00,000	Depreciation on Bank's properties	30,000
Directors' fees and allowances	30,000	Stationery expenses	40,000
Rent and taxes paid	90,000	Preliminary expenses	25,000
Postage and telegrams	60,286	Auditors' fees	5,000
Statutory reserve fund	8,00,000		

Other information :

(a) Transfer 25% of Profit to Statutory Reserve.
(b) Provide ₹ 6,50,000 for doubtful debts.
(c) Rebate on bills discounted on 31.3.2015 was ₹ 12,000 and on 31.3.2016 was ₹ 16,000.
(d) Provide ₹ 6,50,000 for Income tax.
(e) The directors desire to declare 10% dividends.

Prepare the Profit and Loss Account of New Era Bank Ltd for the year ended on 31.3.2016.

[C.A. (Inter) — Adapted]

Solution

New Era Bank Ltd
Profit and Loss Account for the year ended 31st March, 2016

	Schedule No.	Year ended 31.3.2016 (Current Year)
I. **Income**		
Interest earned	13	37,01,738
Other income	14	4,55,000
Total		41,56,738
II. **Expenditure**		
Interest expended	15	20,37,452
Operating expenses	16	4,80,286
Provisions and contingencies (Note 1)		13,00,000
Total		38,17,738
III. **Profit / Loss**		
Net Profit / Loss (–) for the year (I - II)		3,39,000
Profit / Loss (–) brought forward		—
Total		3,39,000

IV. **Appropriations**		
Transfer to statutory reserves (25% of Net Profit)		84,750
Transfer to other reserves		—
Proposed dividend (10% of ₹ 10,00,000)		1,00,000
Corporate Dividend Tax @ 17%		17,000
Balance carried over to Balance Sheet		1,37,250
Total		3,39,000

Working Note : Calculation of Provisions and Contingencies	₹
Provision for doubtful debts	6,50,000
Provision for Income tax	6,50,000
	13,00,000

Schedule 13 : Interest Earned			₹
I. Interest and Discount received		37,05,738	
Add : Opening bal. of rebate on bill discounted	12,000		
		37,17,738	
Less : Closing bal. of rebate on bill discounted	16,000		37,01,738
II. Income on Investments			—
III. Interest on bal. with RBI & other inter-bank funds			—
IV. Others			—
Total			37,01,738

Schedule 14 : Other Income	₹
I. Commission, exchange and brokerage	1,90,000
II. Rent received	65,000
III. Net Profit on sale of investments	2,00,000
IV. Net Profit on revaluation of investments	—
Less : Net Loss on revaluation of investments	—
V. Net Profit on sale of land, buildings & other assets	—
Less : Net Loss on sale of land, buildings & other assets	—
VI. Net Profit on exchange transactions	
VII. Income earned by way of dividends etc from subsidiaries / joint ventures setup abroad/in India	—
VIII. Miscellaneous Income	—
Total	4,55,000

Schedule 15 : Interest Expended	₹
I. Interest on Deposits	20,37,452
II. Interest on RBI / Inter-bank borrowings	—
III. Others	—
Total	20,37,452

Schedule 16 : Operating Expenses	₹
I. Payment to and provision for employees	2,00,000
II. Rent, taxes and lighting	90,000
III. Printing and stationery	40,000
IV. Advertisement and publicity	—
V. Depreciation on Bank's property	30,000
VI. Directors' fees and allowances	30,000
VII. Auditor's fees and expenses	5,000
VIII. Law charges	—
IX. Postage and telegram	60,286
X. Repairs and maintenance	—
XI. Insurance	—
XII. Other expenditure	25,000
Total	4,80,286

Illustration 26

From the following information, prepare Profit and Loss Account of Vasavi Bank Ltd for the year ended on 31st March, 2016.

	₹ ('000)		₹ ('000)
Interest on loans	300	Interest on temporary overdrafts in current accounts	30
Interest on fixed deposits	275	Interest on Savings Bank deposits	87
Commission	10	Postage, telegram and stamps	10
Exchange and brokerage	20	Printing & Stationery	20
Salaries and allowances	150	Sundry expenses	10
Discount on bills (Gross)	152	Rent	15
Interest on cash credits	240	Taxes and licences	10
		Audit fees	10

Additional information :

(1) Rebate on bills discounted ₹ 30,000;
(2) Salary of Managing Director ₹ 30,000;
(3) Provision for bad debts ₹ 40,000;
(4) Provision for Income tax is to be made for ₹ 34,000; and
(5) Interest of ₹ 4,000 on doubtful debts was wrongly credited to interest on loans account.

Working should form part of your answer.

[C.S. (Inter) — Adapted]

Solution

Vasavi Bank Ltd
Profit and Loss Account for the year ended 31st March, 2016

(000's omitted)

	Schedule No.	Year ended 31.3.2016 (Current Year)
I. **Income**		
Interest earned	13	688
Other income	14	30
Total		718
II. **Expenditure**		
Interest expended	15	362
Operating expenses	16	255
Provisions and contingencies (Note 1)		74
Total		691
III. **Profit / Loss**		
Net Profit / Loss (–) for the year		27
Profit / Loss (–) brought forward		—
Total		27
IV. **Appropriations**		
Transfer to statutory reserves (25% of Net Profit)		*7
Transfer to other reserves		—
Balance carried over to Balance Sheet		20
Total		27

* Rounded off.

Tutorial Note : Interest on doubtful debts is not recognised on **accrual basis** but is booked as income only when it is **actually received**. Therefore, banks should not charge and take to income account interest on all non-performing assets.

(1) Calculation of Provisions & Contingencies	₹ ('000)
Provision for bad debts	40
Provision for taxation	34
	74

(2) Interest and Discounts	₹ ('000)
Interest on loans	300
Discount on bills	152
Interest on cash credits	240
Interest on temporary overdraft	30
	722
Less: Interest on doubtful debts (see Tutorial Note)	4
	718

Schedule 13 : Interest Earned			₹ ('000)
I. Interest and Discount received (Note 2)		718	
Add : Opening bal. of rebate on bill discounted	Nil		
		718	
Less : Closing bal. of rebate on bill discounted		30	688
II. Income on Investments			—
III. Interest on balances with RBI and other inter-bank fund			—
IV. Others			—
Total			688

Schedule 14 : Other Income	₹ ('000)
I. Commission, exchange and brokerage	30
II. Rent received	—
III. Net Profit on sale of investments	—
IV. Net Profit on revaluation of investments	—
Less : Net Loss on revaluation of investments	—

Schedule 15 : Interest Expended	₹ ('000)
I. Interest on Deposits (₹ 275 + 87)	362
II. Interest on RBI / Inter-bank borrowings	—
III. Others	—
Total	362

Schedule 16 : Operating Expenses	₹ ('000)
I. Payment to and provision for employees	*150
II. Rent, taxes and lighting	25
III. Printing and stationery	20
IV. Advertisement and publicity	—
V. Depreciation on Bank's property	—
VI. Directors' fees and allowances	30
VII. Auditor's fees and expenses	10
VIII. Law charges	—
IX. Postage and telegram	10

V. Net Profit on sale of land, buildings & other assets	—	X. Repairs and maintenance	—
Less : Net Loss on sale of land, buildings & other assets	—	XI. Insurance	—
VI. Net Profit on exchange transactions		XII. Other expenditure	10
VII. Income earned by way of dividends etc from subsidiaries / joint ventures setup abroad/in India	—	**Total**	255
		*It is assumed that figure of salaries & allowances is exclusive of salary paid to M.D.	
VIII. Miscellaneous Income	—		
Total	30		

Preparation of Balance Sheet

Illustration 27

On 31.3.2016, the following balances stood in the books of New Bank Ltd, after preparing Profit and Loss Account.

The net profit is after deducting provisions for bad debts ₹ 2,10,000, tax provision ₹ 7,00,000 and rebate on bills discounted ₹ 35,000. Prepare the Balance Sheet of the Bank as on 31.3.2016.

Particulars	₹ ('000)	Particulars	₹ ('000)
Share capital	35,00	Cash credit	4,00,00
Reserve fund	24,50	Term Loan	90,00
Fixed deposit accounts	66,50	Cash with other banks	91,00
Savings bank accounts	2,10,00	Borrowings from other banks	44,00
Current accounts	5,60,00	Bills discounted and purchased	42,00
Money at call and short notice	21,00	Sundry creditors	2,10
Investments (at cost)	2,10,00	Bills payable	56,00
Profit and Loss Account (Cr.) 1.4.2015	14,70	Unclaimed dividend	2,10
Dividends for 2015 (incl. Corporate Dividend tax)	3,50	Bills for collection	9,80
Land & buildings (after depreciation up to 31.3.2016)	74,45	Acceptance on behalf of customers	14,00
Cash in hand	4,20	Net Profit for 2015-16	16,80
Cash with RBI	1,05,00		

Solution **Balance Sheet of New Bank Ltd as at 31st March, 2016**

Particulars	Schedule No.	As on 31.3.2016 (Current year)
		₹ ('000)
Capital and Liabilities		
Capital	1	35,00
Reserves and Surplus	2	52,50
Deposits	3	8,36,50
Borrowings	4	44,00
Other Liabilities and Provisions	5	69,65
Total		10,37,65
Assets		
Cash and balances with RBI	6	1,09,20
Balances with banks and money at call and short notice	7	1,12,00
Investment	8	2,10,00
advances	9	5,32,00
Fixed Assets	10	74,45
Other Assets	11	Nil
Total		10,37,65
Contingent Liabilities	12	14,00
Bills for Collection		9,80

Schedule 1 : Capital	₹ ('000)	**Schedule 3 : Deposits**	₹ ('000)
Authorised Capital ... Shares of ₹ . . . each	?	A. I. Demand Deposits	
Issued Capital ... Shares of ₹ . . . each	?	(i) From Banks	—
Subscribed Capital ... Shares of ₹ . . . each	35.00	(ii) From Others	5,60,00
Total	35.00	II. Savings Bank Deposit	2,10,00

Schedule 2 : Reserve and Surplus		₹ ('000)
1. Statutory Reserve		
Opening balance		?
Addition during the year (Note 1)		4,20
II. Capital Reserve		—
III. Share Premium		—
IV. Revenue & Other Reserves		24,50
V. Balance in Profit and Loss Account		
Last year	14,70	
Current year (Note 2)	9,10	23,80
Total (I + II + III + IV + V)		52,50

Schedule 6 : Cash and Balances with RBI	₹ ('000)
I. Cash in hand (including foreign currency notes)	4,20
II. Balances with RBI in :	
(i) Current Account	1,05,00
(ii) Other Accounts	—
Total (I + II)	1,09,20

Schedule 7 : Balance with Bank and Money at Call and Short Notice	₹ ('000)
I. In India	
(i) Balances with Banks	91,00
(ii) Money at Call and Short Notice	
(a) with Banks	21,00
(b) with other Institutions	—
Total (I)	1,12,00
II. Outside India	—
(i) In Current Accounts	
(ii) In Other Deposit Accounts	—
(iii) Money at call and short notice	—
Total (II)	—
Grand Total (I + II)	1,12,00

Schedule 8 : Investments	₹ ('000)
I. Investment in India	2,10,000
II. Investment outside India	—
Total	2,10,000

III. Term Deposits	
(i) From Banks	—
(ii) From Others	66,50
Total (I + II + III)	8,36,50
B. (i) Deposits of branches in India	—
(ii) Deposits of branches outside India	—
Total	8,36,50

Schedule 4 : Borrowings	₹ ('000)
I. Borrowings in India	
(i) RBI	—
(ii) Other Banks	44,00
(ii) Other Institutions and Agencies	—
II. Borrowings Outside India	—
Total (I + II)	44,00

Schedule 5 : Other Liabilities & Provisions	₹ ('000)
I. Bills Payable	56,00
II. Inter-office adjustments (Net)	—
III. Interest accrued	—
IV. Other (including provisions)	
Sundry Creditors	2,10
Unclaimed dividends	2,10
Provision for bad debts	2,10
Provision for tax	7,00
Rebate on bill discount	35
Total (I + II + III + IV)	69,65

Schedule 10 : Fixed Assets	₹ ('000)
I. Premises :	74,45
At cost and as on 31st March of the preceding year	
II. Other Fixed Assets (incl. Furniture and Fixtures)	
Total	74,45

Schedule 9 : Advances	₹ ('000)
A. (i) Bills Discounted and Purchased	42,00
(ii) Cash credits, Overdrafts & Loans payable on demand	4,00,00
(iii) Term Loans	90,00
Total	5,32,00

Working Notes :

(1) As per latest guidelines, Statutory Reserve is to be created @ 25% of Net Profit. Therefore, statutory reserve = 25% of ₹ 16,80,000 = ₹ 4,20,000.

(2) Profit and Loss Appropriation	₹ ('000)
Profit for the year 2015-16	16,80
Less: Statutory reserve	4,20
	12,60
Less: Dividend for 2015 (including Corporate Dividend tax)	3,50
Balance transferred to Schedule : 2	9,10

Illustration 28

From the following information, prepare a Balance Sheet of International Bank Ltd as on 31st March, 2016 giving the relevant schedules (all figures in ₹ lakhs) :

Particulars	Dr. (₹)	Cr. (₹)
Share capital : 19,80,000 shares of ₹ 10 each		198.00
Statutory Reserve		231.00
Net Profit before Appropriation		150.00
Profit and Loss Account		412.00
Fixed Deposit Account		517.00
Savings Deposit Account		450.00
Current Accounts	28.00	520.12
Bills Payable		0.10
Cash Credits	812.10	
Borrowings from other Banks		110.00
Cash in Hand	160.15	
Cash with RBI	37.88	
Cash with other Banks	155.87	
Money at Call	210.12	
Gold	55.23	
Government Securities	110.17	
Premises	155.70	
Furniture	70.12	
Term Loan	792.88	
	2,588.22	2,588.22

Additional information :	₹
Bills for collection	18,10,000
Acceptances and endorsements	14,12,000
Claims against the Bank acknowledged as debt	55,000
Depreciation charges — Premises	1,10,000
Furniture	78,000

50% of the Term Loans are secured by Government guarantees, 10% of cash credit is unsecured. Also calculate cash reserves required and statutory liquid reserves required.

Note : Cash reserve required 3% of demand and time liabilities; liquid reserves required 30% of demand and time liabilities. ***[C.A. (Inter) — Adapted]***

Solution **Balance Sheet of International Bank Ltd as at 31st March, 2016**

Particulars	Schedule No.	As on 31.3.2016 (Current year)
		₹ (Lakhs)
Capital and Liabilities		
Capital	1	198.00
Reserves & Surplus	2	793.00
Deposits	3	1,487.12
Borrowings	4	110.00
Other Liabilities and Provisions	5	0.10
Total		2,588.22
Assets		
Cash and balances with RBI	6	204.76
Balances with banks and money at call and short notice	7	359.26
Investment	8	165.40
advances	9	1,632.98
Fixed Assets	10	225.82
Other Assets	11	—
Total		2,588.22
Contingent Liabilities	12	14.67
Bills for Collection		18.10

Schedule 1 : Capital		₹ (Lakhs)
Authorised Capital ... Shares of ₹ 10 each		?
Issued Capital ... Shares of ₹ 10 each		?
Subscribed Capital ... Shares of ₹ 10 each		?
Called-up Capital : 19,80,000 Shares of ₹ 10 each		198.00
Total		198.00

Schedule 2 : Reserve and Surplus		₹ (Lakhs)
1. Statutory Reserve		
Opening balance	231.00	
Addition during the year (Note 1)	37.50	268.50
II. Capital Reserve		—
III. Share Premium		—
IV. Revenue & Other Reserves		—
V. Balance in Profit and Loss Account		
Last year	412.00	
Current year (Note 2)	112.50	524.50
Total (I + II + III + IV + V)		793.00

Schedule 6 : Cash and Balances with RBI	₹ (Lakhs)
I. Cash in hand (including foreign currency notes)	160.15
II. Balances with RBI in :	
(i) Current Account (Note 3)	44.61
(ii) Other Accounts	—
Total (I + II)	204.76

Schedule 7 : Balance with Bank and Money at Call and Short Notice	₹ (Lakhs)
I. In India	
(i) Balances with Banks	
(a) in Current Account (Note 4)	149.14
(b) in Other Deposit Accounts	210.12
(ii) Money at Call & Short Notice	—
Total (I)	359.26
II. Outside India	—
Total (II)	—
Grand Total (I + II)	359.26

Schedule 8 : Investments	₹ (Lakhs)
I. Investment in India	
(i) Government Securities	110.17
(ii) Others — Gold	55.23
II. Investment outside India	—
Total	165.40

Schedule 9 : Advances	₹ (Lakhs)
A. (i) Bills Discounted and Purchased	—
(ii) Cash credits, Overdrafts & Loans payable on demand	840.10
(iii) Term Loans	792.88
Total	1,632.98

Schedule 3 : Deposits	₹ (Lakhs)
A. I. Demand Deposits	
(i) From Banks	—
(ii) From Others	520.12
II. Savings Bank Deposit	450.00
III. Term Deposits	
(i) From Banks	—
(ii) From Others	517.00
Total (I + II + III)	1,487.12
B. (i) Deposits of branches in India	—
(ii) Deposits of branches outside India	—
Total	1,487.12

Schedule 4 : Borrowings	₹ (Lakhs)
I. Borrowings in India	
(i) RBI	—
(ii) Other Banks	110.00
(ii) Other Institutions & Agencies	—
II. Borrowings Outside India	—
Total (I + II)	110.00

Schedule 5 : Other Liabilities & Provisions	₹ (Lakhs)
I. Other Liabilities and Provisions	0.10

Schedule 10 : Fixed Assets		₹ (Lakhs)
I. Premises :		
At cost and as on 31st March of the preceding year	156.80	
Less : Depreciation to date	1.10	155.70
II. Other Fixed Assets (including Furniture & fixtures)		
At cost and as on 31st March of the preceding year	70.90	
Less: Depreciation to date	0.78	70.12
		225.82

Schedule 12 : Contingent Liabilities	₹ (Lakhs)
I. Claims against the Bank not acknowledged as debts	0.55
II. Liability for partly paid investments	—
III. Liability of account of outstanding forward exchange contracts	—
IV. Guarantees given on behalf of constituents	—
V. Acceptances, Endorsements and Other Obligations	14.12
VI. Other Items for which Bank is contingently liable	—
Total	14.67

Calculation of Cash Reserve and Statutory Liquid Reserve	₹ in lakhs
Total of demand and time liability (Schedule 3)	1,487.12
(i) Cash Reserve — 3% of ₹ 1,487.12 Lakhs	44.61
(ii) Statutory Liquid Reserve — 30% of ₹ 1,487.12 Lakhs	446.14

Working Notes :

(1) As per latest guideline, statutory reserve is to be created @ 25% of Net Profit. Therefore, statutory reserve = 25% of ₹ 150 lakhs = ₹ 37.50 lakhs.

(2) Profit and Loss Appropriation	₹ (Lakhs)
Profit for the year 1993-94	150.00
Less: Statutory Reserve @ 25%	37.50
Balance transferred to Schedule : 2	112.50

(3) Transfer from Cash with other Banks to Cash with RBI	₹ (Lakhs)
Cash reserve required (3% of ₹ 1,487.12 Lakhs)	44.61
Cash with RBI	37.88
Transfer required to maintain Cash Reserve	6.73

(4) Liquid Assets	₹ (Lakhs)
Cash in Hand	160.15
Cash with Other Banks	155.87
Money at Call and Short Notice	210.12
Gold	55.23
Government Securities	110.17
Present Liquidity	691.54
Required Liquidity	446.14
Excess Liquidity	245.40

Excess liquidity will enable the transfer of ₹ 6.73 Lakhs from Cash with Other Banks to Cash with RBI. Therefore, after transfer cash with other banks will be : (₹ 155.87 Lakhs – ₹ 6.73 Lakhs) = ₹ **149.14 Lakhs**.

Illustration 29

From the following, prepare the Final Accounts of Barnali Bank Ltd for the year ending on 31st March, 2016

Particulars	Dr. (₹)	Cr. (₹)	Particulars	Dr. (₹)	Cr. (₹)
Share Capital : 1,00,000 shares of ₹ 10 each (₹ 5 paid up)		5,00,000	Money at call and short notice	3,00,000	
			Interest accrued and paid	2,00,000	
Reserve fund		10,00,000	Salaries	80,000	
Fixed deposits		20,00,000	Rent	30,000	
Savings Bank deposits		30,00,000	Profit and Loss Account (1.4.2015)		1,60,000
Current Accounts		70,00,000	Interest earned		4,50,000
Borrowed from bank		2,00,000	Bills discounted	5,00,000	
Investments	30,00,000		Bills payable		8,00,000
Premises	12,00,000		Loans, advances, overdraft and credits	70,00,000	
Cash in hand	60,000		Unclaimed dividends		30,000
Cash at Bank	28,00,000		Sundry creditors		30,000
				1,51,70,000	1,51,70,000

The bank had the bills for ₹ 14,00,000 as collection for its constituents and also, acceptances and endorsements for them amounting to ₹ 4,00,000.

Solution **Balance Sheet of Barnali Bank Ltd as at 31st March, 2016**

Particulars	Schedule No.	As on 31.3.2016 (Current Year)
Capital and Liabilities		₹ ('000)
Capital	1	500
Reserves & Surplus	2	1,300
Deposits	3	12,000
Borrowings	4	200
Other Liabilities and Provisions	5	860
Total		14,860
Assets		
Cash and balances with RBI	6	60
Balances with banks and money at call and short notice	7	3,100
Investment	8	3,000
Advances	9	7,500
Fixed Assets	10	1,200
Other Assets	11	—
Total		14,860
Contingent liabilities	12	400
Bills for collection		1,400

Barnali Bank Ltd
Profit and Loss Account for the year ended 31st March, 2016

Particulars	Schedule No.	Year ended 31.3.2016 (Current Year)
I. **Income**		₹ ('000)
Interest earned	13	450
Other income	14	—
Total		450
II. **Expenditure**		
Interest expended	15	200
Operating expenses	16	110
Provisions and contingencies		Nil
Total		310
III. **Profit / Loss**		
Net profit / Loss (–) for the year (I - II)		140
Total		140
IV. **Appropriations**		
Transfer to statutory reserves (25% of Net Profit)		35
Transfer to other reserves		—
Transfer to Government / proposed dividend		—
Balance carried over to Balance Sheet		105
Total		140

Schedule 1 : Capital		₹ ('000)
Authorised Capital ... Shares of ₹ 10 each		?
Issued Capital ... Shares of ₹ 10 each		?
Subscribed Capital ... Shares of ₹ 10 each		?
Called-up Capital : 1,00,000 Shares of ₹ 10 each ₹ 5 each paid-up		500
Less: Calls unpaid		—
Add : Forfeited shares		—
Total		500

Schedule 2 : Reserve and Surplus		₹ ('000)
1. Statutory Reserve		
Opening balance	1,000	
Addition during the year	35	1,035
II. Capital Reserve		
III. Share Premium		
IV. Revenue & Other Reserves		
V. Balance in Profit and Loss Account		
Last year	160	
Current year	105	265
Total (I + II + III + IV + V)		1,300

Schedule 6 : Cash and Balances with RBI	₹ ('000)
I. Cash in hand (including foreign currency notes)	60
II. Balances with RBI in	—
Total (I + II)	60

Schedule 7 : Balance with Bank and Money at Call and Short Notice	₹ ('000)
I. In India	
(i) Balances with Banks	2,800
(ii) Money at Call & Short Notice	300
II. Outside India	
Total (I + II)	3,100

Schedule 3 : Deposits	₹ ('000)
A. I. Demand Deposits	
(i) From Banks	7,000
(ii) From Others	
II. Savings Bank Deposit	3,000
III. Term Deposits	
(i) From Banks	2,000
(ii) From Others	
Total (I + II + III)	12,000
B. (i) Deposits of branches in India	12,000
(ii) Deposits of branches outside India	—
Total	12,000

Schedule 4 : Borrowings	₹ ('000)
I. Borrowings in India	
(i) RBI	—
(ii) Other Banks	200
(ii) Other Institutions & Agencies	—
II. Borrowings Outside India	—
Total (I + II)	200

Schedule 5 : Other Liabilities & Provisions	₹ ('000)
I. Bills Payable	800
II. Inter-office adjustments (Net)	—
III. Interest accrued	—
IV. Other (including provisions)	
Sundry Creditors	30
Unclaimed dividends	30
Total (I + II + III + IV)	860

Schedule 10 : Fixed Assets	₹ ('000)
I. Premises	1,200
II. Other Fixed Assets (including Furniture & fixtures)	—
Total (I + II)	1,200

Schedule 8 : Investments	₹ ('000)
I. Investment in India	3,000
II. Investment outside India	—
Grand Total (I + II)	3,000

Schedule 9 : Advances	₹ ('000)
A. (i) Bills Discounted and Purchased	500
(ii) Cash credits, Overdrafts & Loans payable on demand	7,000
(iii) Term Loans	—
Total	7,500

Schedule 13 : Interest Earned		₹ ('000)
I. Interest and discount received	450	
Add : Op. bal. of rebate on bill discounted	—	
	450	
Less : Clos.bal. of rebate on bill discounted	—	450
II. Income on Investments		—
III. Interest on bal. with RBI and other inter-bank fund		—
IV. Others		—
Total		450

Schedule 15 : Interest Expended	₹ ('000)
I. Interest on Deposits	—
II. Interest on RBI / Inter-bank borrowings	200
III. Others	—
Total	200

Schedule 11 : Other Assets	₹ ('000)
I. Inter-office Adjustments (Net)	
II. Interest Accrued	
III. Tax paid in Advance / Tax Deducted at Source	
IV. Stationery and Stamps	Nil
V. Non-banking assets acquired in satisfaction of claims	
IV. Others	
Total	Nil

Schedule 12 : Contingent Liabilities	₹ ('000)
I. Claims against the Bank not acknowledged as debts	—
II. Liability for partly paid investments	—
III. Liability of account of outstanding forward exchange contracts	—
IV. Guarantees given on behalf of constituents :	
(i) in India	—
(ii) outside India	—
V. Acceptances, Endorsements and Other Obligations	400
VI. Other items for which bank is contingently liable	—
Total	400

Schedule 16 : Operating Expenses	₹ ('000)
I. Payment to and provision for employees	80
II. Rent, taxes and lighting	30
Total	110

Illustration 30

The following Trial Balance was extracted from the books of the Citizens Bank Ltd, as on 31st March, 2016:

Particulars	Dr.(₹)	Cr. (₹)	Particulars	Dr. (₹)	Cr. (₹)
Share Capital		3,00,000	Bills Discounted and Purchased	12,500	
Cash in hand and with RBI	46,350		Bills for Collection		43,500
Investments in Govt. of India Bonds	1,94,370		Acceptances and Endorsements		56,500
Other Investments	1,55,630		Interests	7,950	72,000
Gold Bullion	15,130		Commission and Brokerage		25,300
Interest accrued on Investments	24,620		Discounts		42,000
Security Deposits of Employees		15,000	Bills Receivable being bills for collection	43,500	
Savings Account Balance		7,420	Audit fees	5,000	
Current Ledger Control Account		97,000	Loss on sale of Furniture	1,000	
Fixed Deposits		23,050	Directors' fees	1,200	
Share Premium Account		90,000	Salaries	21,200	
Statutory Reserve		1,40,000	Postage	50	
Silver Bullion	2,000		Rents		600
Constituents' Liability for acceptance and endorsements	56,500		Profit on Bullion		1,200
			Managing Director's Remuneration	12,000	
Buildings	65,000		Miscellaneous income		2,700
Furniture	5,000		Loss on sale of investments	30,000	
Borrowings from Banks		77,230	Deposit with other Banks	75,000	
Money at Call and Short Notice	26,000		Branch Adjustments	20,000	
Advances	2,00,000		Depreciation Reserve on Building		20,000
Profit and Loss Account Balance		6,500	**Total**	10,20,000	10,20,000

You are required to prepare a Profit and Loss Account for the year ended on 31st March, 2016 and also the Balance sheet after considering the following :

(i) Provide rebate on bills discounted : ₹ 5,000.

(ii) A scrutiny of the Current Account Ledger reveals that there are accounts overdrawn to the extent of ₹ 25,000 and the total of the credit balances is ₹ 1,22,000.

(iii) Claims by employees for bonus amounting to ₹ 15,000 is pending award of arbitration.

(iv) Depreciation on building for the year amounts to ₹ 5,000.

(v) Out of profit for the year, 25 per cent thereof were transferred to Statutory reserve, and the Directors proposed a dividend of 8 per cent, subject to deduction of tax. ***[C.A. (Inter) — Adapted]***

Solution **Balance Sheet of Citizen Bank Ltd as at 31st March, 2016**

Particulars	Schedule No.	As on 31.3.2016 (Current Year)
Capital and Liabilities		
Capital	1	3,00,000
Reserves and Surplus	2	2,63,820
Deposits	3	1,52,470
Borrowings	4	77,230
Other Liabilities and Provisions	5	48,080
Total		8,41,600
Assets		
Cash and balances with RBI	6	46,350
Balances with banks and money at call and short notice	7	1,01,000
Investments	8	3,65,130
Advances	9	2,37,500
Fixed Assets	10	45,000
Other Assets	11	46,620
Total		8,41,600
Contingent liabilities	12	71,500
Bills for collection		43,500

Citizen Bank Ltd
Profit and Loss Account for the year ended 31st March, 2016

	Schedule No.	Year ended 31.3.2016 (Current Year)
I. **Income**		
Interest earned	13	1,09,000
Other income	14	(1,200)
Total		1,07,800
II. **Expenditure**		
Interest expended	15	7,950
Operating expenses	16	44,450
Provisions and contingencies		—
Total		52,400
III. **Profit / Loss**		
Net Profit / Loss (–) for the year (I - II)		55,400
Total		55,400
IV. **Appropriations**		
Transfer to statutory reserves (25% of Net Profit)		13,850
Transfer to other reserves		—
Proposed dividend (8% 0f ₹ 3,00,000)		24,000
Corporate dividend tax @ 17%		4,080
Balance carried over to Balance Sheet		13,470
Total		55,400

Schedule 1 : Capital

	₹
Authorised Capital ... Shares of ₹ ... each	?
Issued Capital ... Shares of ₹ ... each	?
Subscribed Capital ... Shares of ₹ ... each	?
Called-up Capital ... Shares of ₹ ... each	3,00,000
Total	3,00,000

Schedule 2 : Reserve & Surplus

		₹
1. Statutory Reserve		
Opening balance	1,40,000	
Addition during the year	13,850	1,53,850
II. Capital Reserve		—
III. Share Premium		—

Schedule 3 : Deposits

	₹
A. I. Demand Deposits	
(i) From Banks (₹ 97,000 + ₹ 25,000)	1,22,000
(ii) From Others	—
II. Savings Bank Deposit	7,420
III. Term Deposits	
(i) From Banks	
(ii) From Others	23,050
Total	1,52,470
B. (i) Deposits of branches in India	1,52,470
(ii) Deposits of branches outside India	
Total	1,52,470

Opening balance	90,000	
Additions during the year	—	
Deductions during the year	—	90,000
IV. Revenue & Other Reserves		—
V. Balance in Profit and Loss Account		
Last year	6,500	
Current year	13,470	19,970
Total (I + II + III + IV + V)		2,63,820

Schedule 6 : Cash and Balances with RBI

	₹
I. Cash in hand (including foreign currency notes)	46,350
II. Balances with RBI in	
Total (I + II)	46,350

Schedule 7 : Balance with Bank and Money at Call and Short Notice

	₹
I. In India	
(i) Balances with Banks	
(a) in Current Accounts	75,000
(b) in Other Deposit Accounts	—
(ii) Money at Call & Short Notice	
(a) with Banks	26,000
(b) with other Institutions	—
II. Outside India	—
Total (I + II)	1,01,000

Schedule 8 : Investments

	₹
I. Investment in India (Note 1)	
Govt. securities	1,94,370
Debentures and Bonds	1,55,630
Gold	15,130
II. Investment outside India	—
Grand Total (I + II)	3,65,130

Schedule 9 : Advances

A. (i) Bills Discounted and Purchased	12,500
(ii) Cash credits, Overdrafts & Loans payable on demand (₹ 2,00,000 + ₹ 25,000)	2,25,000
Total	2,37,500

Schedule 13 : Interest Earned

		₹
I. Interest and discount received	1,14,000	
Add : Op.bal. of rebate on bill discounted	—	
1,14,000		
Less : Clos. bal. of rebate on B/discounted	5,000	1,09,000
II. Income on Investments		—
III. Interest on bal. with RBI and other inter-bank funds		—
IV. Others		—
Total		1,09,000

Schedule 15 : Interest Expended

	₹
I. Interest on Deposits	
II. Interest on RBI / Inter-bank borrowings	7,950
III. Others	—
Total	7,950

Schedule 14 : Other Income

		₹
I. Commission, exchange and brokerage		25,300
II. Rent received		600
III. Net Profit on sale of investments	1,200	
Less : Net Loss on sale of investments	30,000	(28,800)
IV. Net Profit on revaluation of investments		—

Schedule 4 : Borrowings

	₹
I. Borrowings in India	
(i) RBI	
(ii) Other Banks	77,230
(ii) Other Institutions & Agencies	
II. Borrowings Outside India	—
Total (I + II)	77,230
Secured Borrowings in I & II above	77,230

Schedule 5 : Other Liabilities & Provisions

			₹
I. Bills Payable			—
II. Inter-office adjustments (Net)			—
III. Interest accrued			—
IV. Other (including provisions)			—
Corporate Dividend tax	4,080		
Proposed Dividend		24,000	
Provision for Rebate		5,000	
Security Deposit of Employees		15,000	48,080
Total (I + II + III + IV)			48,080

Schedule 10 : Fixed Assets

	₹
I. Premises :	
At cost & as on 31st March of preceding year	65,000
Additions during the year	—
Deductions during the year	—
Depreciations to date	25,000
II. Other Fixed Assets (including Furniture & Fixtures)	40,000
At cost and as on 31st March of preceding year	5,000
Additions during the year	
Deductions during the year	
Depreciations to date	
Total (I + II)	45,000

Schedule 11 : Other Assets

	₹
I. Inter-office Adjustments (Net)	20,000
II. Interest Accrued on Investments	24,620
III. Tax paid in Advance / Tax Deducted at Source	—
IV. Stationery and Stamps	
V. NBA acquired in satisfaction of claims	
IV. Others (Silver)	2,000
Total	46,620

Schedule 12 : Contingent Liabilities

	₹
I. Claims against the Bank not acknowledged as debts	*15,000
II. Liability for partly paid investments	
III. Liability of account of outstanding forward exchange contracts	
IV. Guarantees given on behalf of constituents :	
(i) in India	
(ii) outside India	
V. Acceptances, Endorsements and Other Obligations	
VI. Other items for which bank is contingently liable	56,500
Total	71,500

* Claim by employees for bonus for ₹ 15,000 is pending award of arbitration.

Schedule 16 : Operating Expenses

	₹
I. Payment to and provision for employees *	33,200
II. Rent, taxes and lighting	—
III. Printing and stationery	—
IV. Advertisement and publicity	—
V. Depreciation on Banker's property	5,000
VI. Directors' fees and allowances	1,200

V. Net Profit on sale of land, buildings & other assets	(1,000)	VII. Auditor's fees and expenses	5,000
Less : Net Loss on sale of furniture	—	VIII. Law charges	—
VI. Net Profit on exchange transactions		IX. Postage and telegram	50
VII. Income earned by way of dividends etc from subsidiaries / joint ventures setup abroad/in India	—	X. Repairs and maintenance	—
		XI. Insurance	—
VIII. Miscellaneous Income	2,700	XII. Other expenditure	—
Total	(1,200)	Total	44,450
		* (₹ 21,200 + 12,000)	

Capital Adequacy Ratio

On the recommendations of Narasimhan Committee, Reserve Bank of India introduced in April 1992 the risk-weighted asset ratio system. It is popularly known as ***Capital Adequacy Ratio*** (CAR). The main idea of this system was to strengthen the capital base of the banks. In order to avoid the risk of insolvency, banks should have adequate capital against advances or other business undertaken by them. At present, banks are required to maintain capital adequacy ratio of 9%. The requirement of maintaining this ratio at a minimum of 9% implies that if a bank makes an advance of ₹ 100, it should have at least ₹ 9 as its capital base. This ratio is computed as follows :

$$\text{Capital Adequacy Ratio} = \frac{\text{Capital Funds}}{\text{Risk–weighted Assets} + \text{Risk–weighted Off Balance Sheet items}} \times 100$$

RBI requires banks to disclose the capital adequacy ratio in notes to the annual accounts.

In this respect the following points are important :

(i) Capital includes reserves and both are to be calculated in the specified manner.

(ii) Assets are not to be taken at absolute amount at which they are appearing in the Balance Sheet. Value of each asset will be adjusted for the risk that it involves.

(iii) Apart from assets appearing in the Balance Sheet, some off-Balance Sheet items (e.g., guarantees given by the bank) are also to be taken into consideration.

Capital

Two categories of capital — Tier I and Tier II are calculated separately.

Tier — I capital is permanent capital and are readily available at the time of crisis.

Tier — II capital is less permanent and are less readily available.

These capitals are calculated as follows :

Computation of Tier - I Capital	₹	₹
Paid-up capital		***
Add: (i) Statutory Reserve	***	
(ii) Other disclosed free reserves including share premium	***	
(iii) Capital reserve arising out of surplus on sale of assets	***	***
		***
Less: (i) Equity investment in subsidiaries	***	
(ii) Intangible assets	***	
(iii) Deferred tax assets	***	
(iv) Accumulated losses till date	***	***
		***

Computation of Tier - II Capital	₹	₹
(i) Undisclosed reserves		***
(ii) Cumulative perpetual preference shares		***
(iii) Revaluation reserve at a discount of 55%		***
(iv) Investment fluctuation reserves		***
(v) General provisions and core reserves		***
(vi) Hybrid debt capital instruments (e.g., convertible debentures)		***
(vii) Subordinated debts (in this respect it should be noted that Bonds issued to employees as part of VRS, as reduced by unamortised deferred VRS expenditure, could be treated as part of subordinated debt provided some conditions are satisifed)		***
		***

Any deferred revenue expenditure related to Voluntary Retirement Scheme (VRS) would not be deducted from Tier — I capital.

Risk-Adjusted Assets and Off-Balance Sheet Items

The value of different assets appearing in the Balance Sheet as well as off-Balance Sheet items are to be adjusted on the basis of degree of risk associated with such assets or items. For this purpose, RBI has allotted a risk weight to each of them. For example, cash balances with RBI and loans guaranteed by the central government have been assigned a risk weight of zero and are thus taken at ***nil*** value. Similarly, loans granted to PSU has been assigned a risk weight of 100% and are thus taken at their full value.

The following table shows the weights to be assigned to the amounts of different assets and off-Balance Sheet items for ***domestic*** operations of a bank.

A. Funded Risk Assets

Sr.No.	Item of Asset or Liability	Risk Weight %
I	**Balances**	
1.	Cash, balances with RBI	0
2.	(i) Balances in current account with other banks	20
	(ii) Claims on Bank / specified financial institutions	20
II	**Investments**	
1.	Investments in Government Securities	2.5
2.	Investments in other approval securities guaranteed by Central / State Government	2.5
3.	Investments in other securities where payment of interest and repayment of principal are guaranteed by Central Government. (This will include investments in Indira / Kisan Vikas Patra and investments in Bonds and Debentures where payment of interest and principal is guaranteed by Central Government.)	2.5
4.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Government.	2.5
5.	Investments in other approved securities where payment of interest and repayment of principal are not guranteed by Central / State Government	20
6.	Investments in Government guranteed securities of Government Undertakings which do not form part of the approved market borrowing programme.	20
7.	Claims on commercial banks and on public financial institutions (PFIs) specified for this purpose	20
8.	Investments in bonds issued by other banks / by specified PFIs	20
9.	Investments in securities which are guaranteed by banks or by specified PFIs as to payment of interest and repayment of principal.	20
10.	Investments in subordinated debt instruments and bonds issued by other banks or PFIs for their Tier — II capital.	100
11.	Deposits placed with SIDBI / NABARD in lieu of shortfall in lending to priority sector.	100
12.	Investment in Mortgage Backed Securities (MBS) of residential assets of Housing Finance Companies (HFCs) which are recognised and supervised by National House Bank (subject to satisfying specified terms and conditions).	50
13.	Investment in securitiesed paper pertaining to an infrastructure facility (subject to satisfying specified terms and conditions).	50
14.	Investments in debentures / bonds / security receipts / Pass Through Certificates issued by Securitisation Company / Reconstruction Company and held by banks as investment	100
15.	All other investments	100
	Note : Equity investments in subsidiaries, intangible assets and losses deducted from Tier — I capital should be assigned zero weight.	
III	**Loans & Advances including bills purchased and discounted and other credit facilities**	
1.	Loans guaranteed by Government of India	0
2.	Loans guaranteed by State Governments. (Loans guaranteed by State Governments where guarantee has been invoked and the concerned State Government has remained in default for a period of more than 180 days (90 days with effect from March 31, 2011) after invocation of the state government guarantee should be assigned a risk weight of 100 per cent.	0
3.	Loans granted to public sector undertakings of Government of India.	100
4.	Loans granted to public sector undertakings of State Government	100

5.	For the purpose of credit exposure, bills purchased / discounted / negotiated under LCs or otherwise should be reckoned on the bank's borrower constituent. Accordingly, the exposure should attract a risk weight appropriate to the borrower constituent for capital adequacy purposes, as under :	
	(i) Government	0
	(ii) Banks / specified PFIs	20
	(iii) Firms, individuals, corporates, etc.	100
6.	Others	100
7.	Leased assets	100
8.	Advances covered by DICGC / ECGC (The risk weight of 50% should be limited to the amount guaranteed and not the entire outstanding balance in the accounts. In other words, the outstandings in excess of the amount guaranteed will carry 100% risk weight.)	50
9.	SSI Advances Guaranteed by Credit Guarantee Fund Trust for Small Industries (CGTSI) up to the guaranteed portion. (Banks may assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion would attract a risk-weight as appropriate to the counter party.)	0
10.	Insurance cover under Business Credit Shield (a product of New India Assurance Company Ltd), subject to specified conditions. (The risk weight of 50% should be limited to the amount guaranteed and not the entire outstanding balance in the accounts. In other words, the outstanding in excess of the amount guaranteed will carry 100% risk-weight.)	50
11.	Advances against term deposits, Life policies, NSCs, IVPs and KVPs where adequate margin is available.	0
12.	Loans and Advances granted to staff of banks which are fully covered by superannuation benefits and mortgage of flat / house.	20
13.	Housing loans to individuals against the mortgage of residential housing properties.	50
14.	Takeout Finance	
	(i) Unconditional takeover (in the books of lending institution)	
	(a) where full credit risk is assumed by the taking-over institution	20
	(b) where only partial credit risk is assumed by taking-over institution	
	(i) the amount to be taken over	20
	(ii) the amount not to be taken over	100
	(ii) Conditional takeover (in the books of lending and taking-over institution)	100
IV	**Other Assets**	
1.	Premises, furniture and fixtures	100
2.	(i) Income tax deducted at source (net of provision)	0
	(ii) Advance tax paid (net of provision)	0
	(iii) Interest due on Government securities	0
	(iv) Accrued interest on CRR balances and claims on RBI on account of Government transactions (net of claims of Government / RBI on banks on account of such transactions)	0
	(v) All other assets	100

B. Off-Balance Sheet Items

For off-Balance Sheet items, the credit risk exposure has to be first calculated by multiplying the face amount of each of the off-Balance Sheet items (*minus* cash margins / deposits) by the 'credit conversion factor' as given in the table below. The resultant figure has to be further multiplied by the weights attributable to the relevant counterparty as specified in the table above.

Sr.No.	Instruments	Credit Conversion Factor (%)	Risk Weight (%)
1.	Direct credit substitutes, e.g., general guarantee of indebtedness (including standby L/Cs serving a financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptance).	100	100
2.	Certain transaction-related contingent items (e.g., performance bonds, bid bonds, warranties and standby L/Cs related to particular transactions).	50	100
3.	Short-term self-liquidating trade-related contingencies (such as documentary credits collateralised by the underlying shipments).	20	100
4.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank.	100	100
5.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown.	100	100
6.	Note issuance facilities and revolving underwriting facilities.	50	100
7.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of over one year.	50	100

8.	Similar commitments with an original maturity upto one year, or which can be unconditionally cancelled at any time.	0	100
9.	Aggregate outstanding foreign exchange contracts of original maturity of —		
	(i) less than one year	2	100
	(ii) for each additional year or part thereof	3	100
10.	Take-out finance in the books of taking-over institution		
	(i) Unconditional take-out finance	100	100
	(ii) Conditional take-out finance	50	100
	Note : As the counterparty exposure will determine the risk weight, it will be 100 per cent in respect of all borrowers or zero percent if covered by Government guarantee.		

Note : In regard to off-Balance Sheet items, the following transactions with non-bank counterparties will be treated as claims on banks and carry a risk-weight of 20%.

(a) Guarantees issued by banks against the counter guarantees of other banks.

(b) Rediscounting of documentary bills accepted by banks. Bills discounted by banks which have been accepted by another bank will be treated as a funded claim on a bank.

In all the above cases, banks should be fully satisfied that the risk exposure is in fact on the other bank.

C. Risk Weights for Open Positions

Sr.No.	Items	Risk weight (%)
1.	Foreign exchange open position	100
2.	Open position in gold	100

Note : The risk weighted position both in respect of foreign exchange and gold open position limits should be added to the other risk weighted assets for calculation of CRAR.

Illustration 31

A Commercial Bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capitals. Find out the risk adjusted asset and risk weighted assets ratio.

Particulars	₹ (Crores)
Equity share capital	500.00
Statutory reserve	270.00
Capital reserve (of which ₹ 16 crores were due to revaluation of assets and the balance due to sale of capital asset)	78.00
Assets :	
Cash balance with RBI	10.00
Balances with other banks	18.00
Other investments	36.00
Loans and advances :	
(i) Guaranteed by the Government	16.50
(ii) Others	5,675.00
Premises, furniture and fixtures	78.00
Off-Balance Sheet items :	
(i) Guarantee and other obligations	800.00
(ii) Acceptances, endorsements and letter of credit	4,800.00

[C.A. (IPCC) — November, 2010]

Solution

(a) Computation of Tier–I Capital

Particulars	₹ (Crores)	₹ (Crores)
Paid-up Equity Share Capital		500
Add: (i) Statutory reserve	270	
(ii) Capital reserve (arising out of sale of assets)	62	332
		832

(b) Computation of Tier–II Capital

Particulars	₹ (Crores)	₹ (Crores)
Capital Reserve due to Revalution of Assets	16	
Less: Discount @ 55%	(8.8)	7.2

Risk Adjusted Assets and Off Balance Sheet Items

Particulars	₹ (Crores)	% Weight	₹ (Crores)
Risk adjusted Assets :			
(a) Cash balances with RBI	10	0	0
(b) Balance with other banks	18	20	3.60
(c) Other investments	36	100	36.00
(d) Loans and Advances :			
(i) Loan guaranteed by Government	16.5	0	0
(ii) Others	5,675	100	5,675.00
(e) Premises, furnitures and fixtures	78	100	78.00
Off Balance Sheet Items :			5,792.60
(i) Gurantee and other obligations	800	100	800.00
(ii) Acceptance, endorsements and letter of credit	4,800	100	4,800.00
Total Risk-adjusted Assets and Off Balance Sheet Items			11,392.60
Total Capital Fund			
Tier–I Capital			832.00
Tier–II Capital			7.20
			839.20

$$\text{Capital Adequacy Ratio} = \frac{\text{Total Capital Fund}}{\text{Total Risk–adjusted Assets and Off Balance Sheet Items}}$$

$$= \frac{839.20}{11,392.60} \times 100 = 7.37 \text{ (rounded off)}$$

Required capital adequacy ratio is 9%. Therefore, the bank is not maintaining required ratio.

Illustration 32

From the following information, calculate :

(a) Tier-I and Tier-II Capital

(b) Capital Adequacy Ratio.

Particulars	₹ in Crore
Capital Funds :	
1. Paid-up Equity Share Capital — 50 crore shares of ₹ 10 each	500
2. Cumulative Perpetual Preference Shares	100
3. Statutory Reserve	100
4. Share Premium	100
5. Capital Reserve (of which ₹ 20 crore were due to revaluation of assets & balance arising out of surplus from sale of assets)	40
6. Investment Fluctuation Reserve	100
Assets :	
1. Cash, balances with RBI	40
2. Equity Investments in Subsidiaries	200
3. Other Investments	200
4. Loans and Advances :	
(i) Loans guaranteed by Government of India	300
(ii) Loan granted to Public Sector Undertaking of Central Government	1,600
(iii) Leased Assets	1,800
(iv) Housing Loan to Individuals against the mortgage of residential house properties	1,000
(v) Premises, furnitures and fixtures	1,500
(vi) Fictitious Assets	9
Off-Balance Sheet Items :	
Endorsement and Letter of Credit	1,000

Solution

(a) Computation of Tier-I Capital

Particulars		₹ in Crore
Paid-up Equity Share Capital — 50 crore shares of ₹ 10 each		500
Add: (i) Statutory Reserve	100	
(ii) Share Premium	100	
(iii) Capital Reserve arising out of surplus from sale of assets	20	220
		720
Less: (i) Equity Investment in Subsidiary	200	
(ii) Intangible Assets	9	209
Total		511

(b) Computation of Tier-II Capital

Particulars		₹ in Crore
(i) Cumulative Perpetual Preference Shares		100
(ii) Capital Reserve due to Revaluation of Assets	20	
Less: Discount @ 55%	11	9
(iii) Investment Fluctuation Reserve		100
Total		209

Risk Adjusted Assets and Off-Balance Sheet Items

Particulars	₹ in Crores	% Weight	Amount in ₹ Crores
Risk Adjusted Assets :			
(i) Cash, balances with RBI	40	0	—
(ii) Other Investment	200	100	200
(iii) Loans and Advances :			
(a) Loans guaranteed by Government of India	300	0	—
(b) Loans granted to PSU	1,600	100	1,600
(c) Leased Assets	1,800	100	1,800
(d) Housing Loan against mortgage of residential house property	1,000	50	500
(iv) Premises, furniture and fixtures	1,500	100	1,500
Off-Balance Sheet Items			5,600
Endorsement and letter of credit	1,000	100	1,000
Total Risk-adjusted Assets and Off-Balance Sheet Items			6,600
Total Capital Fund :			
(i) Tier-I Capital			511
(ii) Tier-II Capital			209
			720

$$\text{Capital Adequacy Ratio} = \frac{\text{Total Capital Fund}}{\text{Total Risk–weighted Assets + Off Balance Sheet items}} \times 100$$

$$= \frac{720 \text{ crore}}{6{,}600 \text{ crore}} \times 100 = 10.91\%$$

Required capital adequacy ratio is 9%. Therefore, the bank is maintaining higher ratio (10.91%) than required.

KEY POINTS

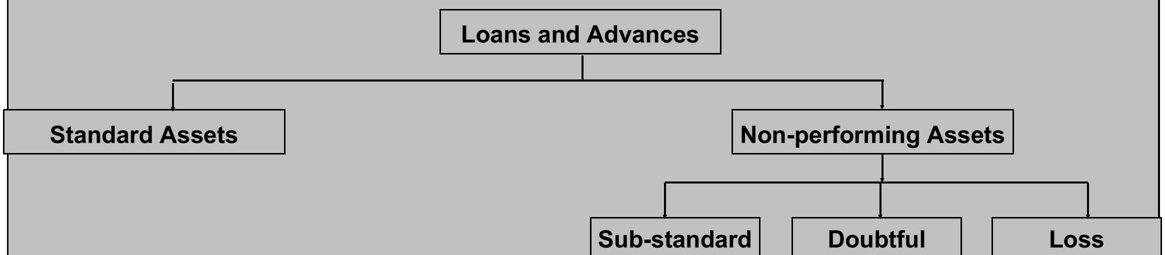
- A bank is a commercial institution, licensed to accept deposits and acts as a safe custodian of the spendable funds of its customers.
- Section 8 of the Banking Regulation Act, 1949, imposes certain restrictions on the business of a banking company. These are as follows:
  - No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realisation of security given to or held by it;
  - No banking company can engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange, received for collection or negotiation or with such of its business or is referred to in clause (a) of sub-section (1) of section 6.
- No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written-off. However, a banking company may pay dividends on its shares without writing-off :
  - the depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

KEY POINTS (contd. ...)

¤ the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;

¤ the bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

- Every banking company incorporated in India shall create a reserve fund and transfer to it at least 20% of its annual profit as disclosed in the Profit and Loss Account prepared under Section 29 and before any dividend is declared. As a further prudential measure, banks have been asked to transfer 25% of the net profit to Statutory Reserve.
- Bank's loans and advances are to be classified into two broad categories — Standard and Non-Performing. Non-performing assets (NPA) are sub-divided into — Sub-standard; Doubtful and Loss assets.



THEORETICAL QUESTIONS

1. What are the restrictions on the business of a banking company ?
   What are the provisions for disposal of non-banking assets ?
2. State the latest guidelines issued by the RBI in respect of payment of dividend.
3. What are the main characteristics of a bank's book-keeping system ? ***[C.A. (Inter) — Nov., 1997]***
4. What do you mean by (i) standard assset; (ii) sub-standard assets and (iii) doubtful assets of a bank ? ***[C.A. (PE-II) — May, 2001]***
5. Write short notes on the following :
   (a) Non-performing assets; (b) Acceptances and Endorsement; (e) Loss Assets.
6. State the guidelines for identification of Non-performing Assets (NPA).
7. What is Capital Adequacy Ratio ? How is it calculated ?

PRACTICAL QUESTIONS

1. The following particulars are extracted from the books of the Commercial Bank Ltd for the year ending 31st March, 2011 :

	₹
(i) Interest and Discounts	1,98,64,800
(ii) Rebate on Bills Discounted (balance on 1.4.2010)	70,080
(iii) Bills Discounted and Purchased	77,46,400

It is ascertained that proportionate discount not yet earned on the Bills Discounted which will mature during 2011-12 amount to ₹ 96,860.

Pass the necessary journal entries with narration adjusting the above and show :

(a) Rebate on Bills Discounted Account; and (b) Interest and Discount Account in the ledger of the Commercial Bank Limited. ***[C.A. (PCC) — May, 2015]***

2. From the following information, find out the amount of discount credited to Profit and Loss Account : Rebate on bills discounted (1.4.2015) ₹ 32,480; Discount received ₹ 1,08,000.
An analysis of the bills discounted shows the following :

Amount of the bill	Rate of Discount	Due Date (including grace days)
73,000	12% p.a.	June 14, 2016
1,46,000	11% p.a.	July 19, 2016
4,38,000	10% p.a.	August 10, 2016

Pass the necessary Journal Entries for the unexpired discount as on 31st March, 2016.

3. The following two term loan accounts were sanctioned by SBI Main Branch, New Delhi on 1st December, 2015. The details are given below :

	Particulars		Loan A/c Ram & Co.	Loan A/c Rahim & Co.
(i)	Amount of Loan	(₹)	7,20,000	12,00,000
(ii)	Period		6 years	6 years
(iii)	Basis of Installments		Quarterly	Half yearly
(iv)	Rate of Interest		12.5%	12.5%
(v)	Amount of Installments	(₹)	30,000 + Interest	1,00,000 + Interest

You are required to find out the date on which these accounts will become NPA assuming that there is no recovery.

4. The following information is available in respect of three bills discounted by SBI, Parliament House Street, New Delhi.

	Particulars		AA Bill	BB Bill	CC Bill
(i)	Amount of Bill	(₹)	2,00,000	2,50,000	3,00,000
(ii)	Date of discounting of the bill		1.8.2015	1.8.2015	1.8.2015
(iii)	Due date of the bill		1.9.2015	1.10.2015	1.2.2016

If the above bills remain unpaid, find out the date when they would be declared NPA. Also mention the Balance Sheet date for NPA declaration.

5. Following are the statements of interest on advances in respect of performing and non-performing assets of H K Bank Ltd Find out the income to be recognised for the year ended 31st March, 2016.

Particulars		Interest Earned (₹ in Lakhs)	Interest Received (₹ in Lakhs)
Performing Assets :	Term Loan	500	420
	Cash Credit and Overdraft	1500	1200
	Bills Purchased and Discounted	600	580
Non-Performing Assets :	Term Loan	400	60
	Cash Credit and Overdraft	600	100
	Bills Purchased and Discounted	350	40

6. Bidisha Bank Ltd had extended the following credit lines to a small-scale industry which had not paid any interest since March, 1995 :

Particulars	Term Loan (₹ in Lakhs)	Export Credit (₹ in Lakhs)
Balance outstanding on 31.3.2001	70	60
DICGC / ECGC Cover	50%	40%
Securities held	30	25
Realisable value of securities	20	15

Compute the necessary provisions to be made for the year ended 31st March, 2001. ***[C.A. (PE-II), May 2002]***

7. The following is an extract from the Trial Balance of a Bank as on 31st March, 2016:
Debit : Bills discounted ₹ 51,50,000.
Credit : Rebate on bills discounted (1.4.2015) ₹ 30,501;
Discount received ₹ 1,45,500.
An analysis of the bills discounted as mentioned above, shows the following :

Date of Bill	Amount (₹)	Period	Rate of Discount
13.1.2016	7,50,000	4 Months	12%
17.2.2016	6,00,000	3 Months	12%
6.3.2016	4,00,000	4 Months	11%
16.3.2016	2,00,000	2 Months	10%

Find out the amount of discount received, to be credited to Profit and Loss Account, and pass appropriate Journal Entries for the same. Show also as to how these items appear in the Balance Sheet.

8. From the following information find out the amount of provisions to be shown in the Profit and Loss Account of a Commercial Bank.

Assets	(₹ in Lakhs)
Standard	4,000
Sub-standard	2,000
Doubtful one year	900
Doubtful three years	400
Doubtful more than three years	300
Loss on Assets	500

[C.A. (PE-II) — Adapted]

Preparation of Profit and Loss Account

8. From the following particulars, prepare the Profit and Loss Account of ABN Bank Ltd for the year ending 31st March, 2016:

Interest on loans	34,90,000	Rent and taxes	1,80,000
Interest on fixed deposits	36,50,000	Interest on overdrafts	12,80,000
Rebate on bills discounted (1.4.2015)	4,80,000	Directors' remuneration	42,000
Commission charged to customers	94,000	Interest on Savings Deposit accounts	6,90,000
Office expenses	15,50,000	Postal expenses	15,000
Discount on bills discounted	19,40,000	Printing and Stationery	39,000
Interest on cash credit	22,40,000	Other expenses	18,000
Amount charged against current accounts	1,20,000		

Adjustments to be made :
(a) Rebate on bills discounted ₹ 5,20,000;
(b) Provide for taxation @ 50% of the profits.

10. From the following information, prepare the Profit and Loss Account of Ganapati Bank Ltd, for the year ended 31st March, 2016:

Interest on Loans	5,18,000	Rent, taxes and lighting	36,000
Interest on Fixed Deposits	5,50,000	Interest on overdrafts	3,08,000
Rebate on Bills discounted	98,000	Directors fees	6,000
Commission	16,000	Auditors fees	4,000
Payments and provisions to employees	8,000	Interest on savings deposits	1,36,000
Discount on bills discounted (net)	2,92,000	Postage and telegrams	3,000
Interest on cash credits	4,46,000	Printing and stationery	6,000
Interest paid on Current Accounts	84,000	Sundry charges	3,000
		Interest on Investments	16,000

Bad Debts to be written-off amounted to ₹ 80,000 and provision for taxation is to be made at 50%.

11. Prepare the Profit and Loss Account of Syndicate Bank Ltd, for the year ended 31st March, 2016 from the following information :

Interest on Loans	2,59,000	Rent and taxes	18,000
Interest on Cash Credits	1,95,000	Directors and Auditors fees	6,000
Interest on Fixed Deposits	2,75,000	Postage and Telegrams	4,000
Interest on Current Accounts	42,000	Printing and Advertisement	3,000
Interest on Govt. Securities	54,000	General expenses	2,000
Interest on inter-bank borrowings	68,000	Bad Debts	12,000
Discount on bills discounted	1,95,000	Profit and Loss Account (Cr.) on 1.4.2015	30,000
Commission and exchange	8,000	Insurance	8,000
Miscellaneous receipts	7,000	Salaries	32,000
Rebate on bills discounted (1.4.2015)	49,000	Contribution to Provident Fund	20,000
Establishment expenses	54,000		

Provide ₹ 8,000 for depreciation, ₹ 20,000 for doubtful debts and ₹ 15,000 for taxation. An interim dividend of ₹ 12,000 was paid. On 31.3.2016 the bills discounted outstanding with an average due date of 22.6.2016 were ₹ 5,00,000, discounted @ 10% p.a.

12. From the following information prepare the Profit and Loss Account of Jawahar Bank Limited for the year ended 31st March, 2015. Also give necessary Schedules.

	₹ in '000
Interest earned on term loans	17.26
Interest earned on term loans classified as NPA	4.52
Interest received on term loans classified as NPA	2.04
Interst on cash credits and overdrafts	38.54
Interest earned but not received on cash credit and overdraft treated as NPA	8.39
Interest on deposits	27.20
Commission	1.97
Profit on sale of investments	11.76
Profit on revaluation of investments	2.76
Income from investments	15.53
Salaries, bonus and allowances	18.75
Rent, taxes and lighting	1.70
Printing and stationary	0.75
Director's fees, allowances expenses	1.33
Law charges	0.22
Repairs and maintenance	0.18
Insurance	0.30
Other Information :	
Make necessary provision on risk assets :	
(i) Sub-standard	15.00
(ii) Doubtful for one year	7.00
(iii) Doubtful for two years	2.40
(iv) Loss assets	0.65
Investments	3700

Bank should not keep more than 25% of its investments as 'held-for-maturity' investment. The market value of rest of its 75% investments is ₹ 9,00,000 as on 31st March, 2015.

[C.A. (IPCC) — May, 2011]

Preparation of Balance Sheet

13. From the following balances of Punjab National Bank Ltd as on 31st March, 2016, prepare its Balance Sheet in the prescribed form :

Paid-up share capital (₹ 100 each fully paid)	20,00,000	Stamps and Stationery	10,000
Bills Discounted	18,00,000	Cash in hand	5,00,000
Reserve Fund	7,70,000	Cash with Reserve Bank	13,00,000
Cash credits	20,00,000	Branch adjustment (Dr.)	1,70,000
Overdrafts	8,00,000	Investments	9,50,000

Unclaimed Dividends	10,000	Loans (Cr.)	12,00,000
Loans	46,00,000	Recurring Deposits	10,00,000
Current Deposits	38,00,000	Fixed Deposits	20,00,000
Furniture	40,000	Cash certificates	10,00,000
Profit and Loss Account (Cr.)	2,20,000	Contingency Reserve	1,70,000

Adjustment :
(a) Rebate on bills discounted ₹ 10,000.
(b) Provide ₹ 80,000 for d oubtful debts.
(c) Bank's acceptances on behalf of customers were ₹ 6,50,000.

14. Prepare the Balance Sheet of Big Bank Ltd as on 31st March, 2016 from the following particulars :

Paid-up Capital	10,00,000	Land and buildings	17,00,000
Authorised Capital	50,00,000	Term loans	8,00,000
Money at call and short notice	5,00,000	Cash credits	3,00,000
Investments	30,00,000	Current Accounts	25,00,000
Bills discounted and purchased	4,00,000	Fixed deposits	14,00,000
Bills payable	5,00,000	Profit for the year	4,00,000
Furniture & fixtures	1,00,000	Cash in hand and with RBI	10,00,000
		Savings Bank Account	10,00,000

The reserve fund is equal to paid-up capital. The profit for the year is arrived at before making adjustment for unexpired discount ₹ 5,000 on bills discounted during the year not matured on 31st March, 2016. Investments include ₹ 5,000 shares of face value ₹ 100 each on which ₹ 60 is paid-up. Claims against the bank not acknowledged as debts amounted to ₹ 50,000.
Acceptance as on 31st March, 2016 are ₹ 2,00,000.

15. The Asoka Bank Ltd owns premises. From the following particulars relating to its accounts, prepare the Balance Sheet as on 31st March, 2016 (all figures in ₹).

Authorised capital	40,00,000	Letters of credit	5,00,000
Subscribed capital :		Telegraphic transfers payable	3,00,000
4,00,000 shares of ₹ 10 each ₹ 5 paid	20,00,000	Bank drafts	7,00,000
Investment	70,00,000	Short loans	40,000
Bills discounted	1,50,00,000	Rebate on bills discounted	10,000
Profit and Loss Account (Cr.)	8,50,000	Acceptances for customers	50,00,000
Endorsement on bills negotiated	1,00,000	Loans	1,00,00,000
Liability of customers for acceptances	50,00,000	Cash credit	1,00,00,000
Money at call and short notice	90,00,000	Bank overdraft	10,00,000
Cash in hand	20,00,000	Bills purchased	10,00,000
Cash with Reserve Bank of India	40,00,000	Current and deposit account	5,60,00,000
Cash with State Bank of India	40,00,000	Investment fluctuation accounts	1,00,000
Reserves	30,00,000	Bills negotiated	1,00,000
Circular notes	10,00,000		

Liability on bills of exchange rediscounted amounts ₹ 3,70,000 and on account of outstanding forward exchange contracts ₹ 2,00,000. ***[Madras M.Com. — Adapted]***

16. Following is the Trial Balance of the Kuber Bank Ltd as on 31st March, 2016 : (₹ '000 omitted)

Loans, cash credits and overdrafts	2,85	*Subscribed Capital :*	
Premises	50	50,000 shares of ₹ 10 each, fully paid	5,00
Indian Govt. Securities	4,00	Reserve Fund	2,50
Interest on Deposits	28	Current Deposits	1,00
General expenses	20	Fixed Deposits	1,25
Rent, taxes and lighting	2	Savings Bank Deposits	50
Director's fees	2	Recurring Deposits	20
Stock of stationery	8	Interest and Discount	1,28
Bills purchased and discounted	46	Miscellaneous	15
Interim Dividend paid	17		
Shares	50		

Cash in hand and with RBI	1,93		
Money at call and short notice	80		
Insurance	7		
	11,88		11,88

Following information should be considered :

(a) Provision for doubtful debts is required amounting to ₹ 5,000.
(b) Interest accrued on investments ₹ 8,000.
(c) Unexpired insurance ₹ 1,000.
(d) Interim dividend declared was 4% actual.
(e) Endorsements on behalf of customers totalled ₹ 1,15,000.
(f) Authorised capital was 80,000 shares of ₹ 10 each. Prepare Profit and Loss Account and Balance Sheet.

17. Some of the items in the trial balance of Modern Bank Ltd as on March 31, 2016 were as follows :

Loans and Advances	71,50,000	Salaries and allowances	82,000
Current Accounts (including O/D of ₹ 15,00,000)	66,00,000	Printing and stationery	4,500
Bills Discounted and Purchased	19,20,000	Interest on Saving Bank Deposits	75,000
Interest on Fixed Deposits	1,55,000	Auditors fees	5,000
Interest on Loans	2,25,000	Directors fees	2,500
Discount (subject to unexpired disc. ₹ 30,000)	2,01,000	Interest on overdrafts	95,000
Interest on cash credits	1,05,000	Provision for bad debts, 1st April 2015	42,000
Commission earned	46,500	Bad debts	21,000
Loss on investment	34,000	Provision for income-tax 1st April 2015	66,000
		Income tax paid for 2015-16	54,000

You are required to prepare the Profit and Loss Account of the Bank, maintaining the provision for income-tax at ₹ 84,000 and provision for doubtful debts at ₹ 52,000 for the year ended March, 2016. All workings should form part of your answer.

[C.A. (Inter) — Adapted]

18. The following are the Ledger Balance (in ₹ thousands) extracted from the books of Vaishnavi Bank Ltd as on March 31, 2016.

Share Capital	1,90,000	Savings Accounts	15,000
Current account control	97,000	Fixed deposits	23,050
Employee security deposits	7,420	Balance with other banks	46,350
Investments in Govt. of India Bonds	94,370	Other investments	55,630
Gold bullion	15,130	Interest accrued on investments	24,620
Silver	2,000	Reserve Fund	1,40,000
Constituents liabilities for acceptances	56,500	Profit and Loss Account (Cr.)	6,500
& endorsements		Bills for collections	43,500
Borrowings from bank	77,230	Interest (Cr.)	62,000
Building	65,000	Loans	1,81,000
Furniture	5,000	Bills discounted	12,500
Money at call and short notice	26,000	Interest	7,950
Commission & brokerage (Cr.)	25,300	Miscellaneous Income	3,900
Discounts (Cr.)	42,000	Depreciation reserve (buildings)	800
Rents (Cr.)	600	Directors' fees	1,000
Audit fees	5,000	Postage	1,250
Depreciation reserve (furniture)	200	Loss on sale of investments	20,000
Salaries	21,200	Branch adjustments (Dr.)	20,000
Rent, rates, taxes	12,000		
Cash in hand with Reserve Bank	75,000		

The bank's Profit and Loss Account for the year ended and Balance Sheet as at 31st March, 2016 are required to be prepared in appropriate form. Further information available are : (in ₹ thousands).

(a) Rebate on bills discounted to be provided ₹ 4,000; (b) Depreciation for the year — Building ₹ 5,000; Furniture ₹ 500; (c) Included in the Current Accounts Ledger are accounts overdrawn to the extent of ₹ 2,500.

[C.A. (Inter) — Adapted]

19. Prepare a Profit and Loss Account for the year ended 31.3.2016 and a Balance Sheet of Mini Bank Ltd as on that date from following Trial Balance on 31st March, 2016 (all figures in ₹) :

Dr.			Cr.
Unissued Capital	2,00,000	Authorised Capital (equity shares of ₹ 100 each)	5,00,000
Uncalled Capital	1,50,000	Commission, Exchange and Brokerage	49,400
Interest paid on Deposits and Borrowings	48,500	Profit on Sale of Gold	35,900
Loss on Sale of Investment	12,600	Short Loans	2,20,000
Provident Fund Contribution	9,200	Reserve Fund (invested in India Govt. Bonds)	80,000
Directors' Fees	5,500	Investment Fluctuation Reserve	20,000
Stationery and Printing	5,600	Current Accounts	5,00,000
Auditors' Fees	1,200	Contingency Accounts	1,00,000
General Expenses	2,700	Profit and Loss Account on 1.4.2015	25,000
Owing by Foreign Correspondents	20,000	Interest and Discount	1,70,000
Overdrafts, Loans, Cash Credits	3,80,000	Savings Bank Deposits	3,55,000
Bank Premises	60,000		
Kerala Government Bond	80,000		
Government of India Securities	4,20,000		
Money at Call and Short Notice	70,000		
Bills Discounted	73,000		
Shares of other companies	17,000		
Cash in hand and with RBI	1,10,000		
Cash at Banks	3,00,000		
Income Tax paid	9,000		
Salaries and Allowances	73,500		
Interim Dividend paid	7,500		
	20,55,300		20,55,300

Additional information :

(i) Interest accrued on investments ₹ 750.

(ii) Markvet value of investments in Government Securities was ₹ 4,75,000 and increase corresponding fluctuation reserve with necessary amount.

(iii) The bills discounted mature at 20th May average date and all bills are discounted at 10% p.a.

(iv) Premises added during the year ₹ 10,000 and provide 5% depreciation on opening Balance.

(v) Provision for taxation on 1.4.2015 stood at ₹ 15,000 which is to be increased to ₹ 28,000.

(vi) Out of the Loans and Advances ₹ 2,50,000 are accrued and ₹ 1,00,000 are guaranteed by Government.

[Mumbai M.com. — Adapted]

20. Progressive Bank Ltd has authorised capital of ₹ 50 lakhs comprising of 50,000 shares of ₹ 100 each, all of which are subscribed. But 70% of the face value of the shares is called up. Bills amounting Rs 4,09,200 are accepted by the bank against security of the value of ₹ 6,20,000 kept with the bank. Depreciation on land and buildings and furniture is to be provided to the extent of ₹ 16,000 and ₹ 7,000 respectively. You are required to prepare Profit and Loss Account and Balance Sheet as on 31st March, 2016 from the following figures : (all figures in ₹)

Share Capital	35,00,000	Profit and Loss Account (Cr.)	1,00,640
Fixed Deposit Accounts	81,81,100	Statutory Reserve Fund	1,40,000
Current Accounts	60,25,664	Loans, Cash credit and overdrafts	1,42,40,000
Savings Bank Deposits	40,46,008	Stamps in hand	372
Bills Payable	2,00,000	Salaries and wages	84,300
Branch Adjustment Account (Cr.)	77,788	Provident fund contribution	20,000
Bills Discounted	29,57,040	Commission, exchange and brokerage	2,00,000
Borrowings from Other Banks in India	5,00,000	Interest paid on deposits, current accounts, etc.	1,25,000
Reserve Fund	4,00,000	Audit fees	3,000
Investments	20,26,250	Directors' fees	10,000
Money at Call and at Short Notice in India	1,02,250	Legal charges	13,300
Land and Buildings (cost : ₹ 6,00,000)	4,10,000	Interest and discounts	5,25,000

Furniture (cost : ₹ 1,04,000)	73,520	Unexpired insurance	874
Cash in hand	8,40,648	Rent, taxes and premium	17,000
Deposit with other banks	23,00,000	Postage and telegrams	6,306
Deposit with Reserve Bank of India	8,00,000	Printing, stationery and advertisement	6,780
Contingency Reserve	1,20,000	Miscellaneous receipts	20,440

[C.S. (Inter) — Adapted]

21. The following is the Trial Balance of Canara Bank Ltd as at 31st March, 2016 : (all figures in ₹)

Dr.
Cr.

Loans, cash credits and overdrafts	4,28,000	Subscribed Capital : 15,000 shares of ₹ 50 each	
Bank premises	75,000	₹ 25 fully paid	3,75,000
Development loan (reserve fund investments)	3,70,000	Reserve Fund	3,70,000
Indian Govt. Securities	2,30,000	Savings Deposits	1,94,000
Interest paid	20,000	Demand Deposits	2,50,000
Salaries	32,000	Term Deposits	3,50,000
General expenses	31,000	Profit and Loss Account Balance as on 1.4.2015	29,000
Rent, rates and taxes	4,000	Interest and discount	1,80,000
Directors' fees	3,000	Brokerage, commission and exchange	42,000
Money at call and short notice	1,20,000		
Income tax paid	13,000		
Bills discounted	70,000		
Interim dividend (paid up to 30th Sept. 2015)	30,000		
Shares in other companies	75,000		
Cash in hand	89,000		
Cash with RBI	1,00,000		
Balance with other banks	1,00,000		
	17,90,000		17,90,000

Prepare Profit and Loss Account for the year ending 31st March, 2016 and a Balance Sheet as on that date after taking into account the following information.
(1) Interest accrued on investments ₹ 10,000; (2) Rebate on bills discounted ₹ 2,000; (3) Interim dividend was declared @ 12%; (4) ₹ 15,000 were added to the premises during the year. Depreciation at 5% on opening balance is to be provided; (5) Endorsements on behalf of the customers were ₹ 1,15,000; (6) The provision for taxation at 1.4.2004 was ₹ 12,000. It is to be maintained at ₹ 31,000; and (7) Authorised capital was 30,00,000 shares of ₹ 50 each.

[I.C.W.A. (Final) — Adapted]

22. Following are the balances from the books of Everymans Bank Ltd as on March 31, 2016 :
(figures in ₹)

Current deposits	2,27,50,000	Bills for collection	90,50,000
Savings Accounts	82,60,000	Liabilities for customers acceptances	75,84,000
Fixed and time deposits	1,75,90,000	Investments :	
Compulsory deposits of Income Tax payers	10,00,000	Government Securities	1,70,00,000
Sundry creditors	2,27,500	Shares	79,50,000
Debts due to banks (secured)	61,00,000	Interest accrued on investments	4,37,500
Bills receivable	90,50,000	Loans	2,08,50,000
Customer's liability for acceptances	75,84,000	Bills purchased and discounted	1,77,50,000
Rebate on bills discounted	7,500	Furniture, fixtures and office equipment	2,50,000
Branch adjustments (credit)	22,77,500	Depreciation on assets	2,50,000
Reserve Fund	62,50,000	Interest paid	6,00,000
Capital (authorised, issued, subscribed & paid-up)		Exchange and commission paid	50,000
1,00,000 shares of ₹ 50 each	50,00,000	Salaries	12,00,000
Interest and discount received	29,00,000	Directors' fees	50,000
Exchange and commission received	8,77,500	Stationery, postage, etc.	2,00,000
Profit and Loss Account		Miscellaneous expenses	1,50,000
Balance as on 1.4.2015 :	4,26,000	Land and building	15,00,000
Cash on hand	6,53,500	Money at call	7,50,000
Cash at bank	30,00,000	Non-banking assets	25,000

Prepare the Profit and Loss Account for the year ending March 31, 2016 and also the Balance Sheet as on that date after taking note of the following :
Provision needed for taxation : ₹ 5,00,000.
Current Account includes ₹ 42,50,000 debit balances being overdraft. One of the Account for ₹ 50,000 (including interest ₹ 5,000) is doubtful. During the year, a property was acquired in satisfaction of a claim amounting to ₹ 25,000 and was sold for ₹ 18,000. The loss resulting therefrom remained unadjusted in the books.

[C.A. (Inter) — Adapted]

Guide to Answers

Practical Questions

1. Provision for unexpired discount ₹ 96,860. Interest and discount credited to Profit and Loss Account ₹ 1,98,38,020.
2. Interest and Discount Account Dr. ₹ 22,480
   To Rebates on Bills Discount Account ₹ 22,480
3. Ram & Co. Account — 29th May, 2016; Rahim & Co. Account — 29th August, 2016.
4.

	AA	BB	CC
Date of NPA Symptom	29.11.2015	29.12.2015	01.05.2016
Balance Sheet date	31.03.2016	31.03.2016	31.03.2009

5. Interest to be recognised as income :

(i) for performing assets (500 + 1,500 + 600)	₹ 2,600 lakhs
(ii) for non-performing assets (60 + 100 + 40)	₹ 200 lakhs
	₹ 2,800 lakhs

6. Provision required : Term Loan — ₹ 35 lakhs; Export credit ₹ 34.50 lakhs.
7. Rebate on bills discounted at the closing of the year ₹ 35,945 (after taking 3 days of grace); Amount credited to Profit and Loss Account ₹ 1,40,056.
8. As per new Circular ₹ 1,501 lakhs.
9. Net profit subject to appropriation ₹ 14,70,000.
10. Net profit ₹ 3,40,000; Transfer to statutory reserve ₹ 85,000 (@ 25% of ₹ 3,40,000).
11. Net profit ₹ 1,70,000; Transfer to statutory reserve ₹ 42,500;
    Balance carried to Balance Sheet ₹ 1,27,500.
12. Loss for the year ₹ 18,54,090. Provision and contingencies ₹ 18,80,610.
13. Net Profit ₹ 1,30,000; Balance Sheet total ₹ 1,21,70,000.
14. Balance Sheet total ₹ 78,00,000; Contingent liabilities ₹ 4,50,000.
15. Balance Sheet total ₹ 640 Lakhs.
16. Net Profit ₹ 88,000; Balance Sheet total ₹ 11,16,000; Contingent liabilities ₹ 1,15,000.
17. Net Profit ₹ 1,81,500
18. Net Profit ₹ 5,59,000
19. Profit ₹ 31,575; Balance Sheet total ₹ 15,28,250.
20. Net Profit ₹ 4,36,754; Balance Sheet total ₹ 2,37,27,954.
21. Net Profit ₹ 1,05,000.
22. Profit for the year ₹ 7,20,500; Balance Sheet total ₹ 7,43,59,000.

17

Investment Accounts

Introduction

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

Investments are classified as under :

(a) A **current investment** is an investment that is by its nature readily realisable and is intended to be held for ***not*** more than one year from the date on which such investment is made. The carrying amount for current investments is the lower of cost or fair value.

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

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

(b) A **non-current investment** is an investment other than a current investment. Non-current investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a non-current investment, the carrying amount is reduced to recognise the decline. The resultant reduction in the carrying amount is charged to the Profit and Loss Account / Statement of Profit and Loss by creating a provision for diminution. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exists.

(c) An **investment property** is held for rental income than the occupation or use. As per the provision of the Companies Act, 2013, ***it is treated as a non-current investment***. In effect, there is no need to provide depreciation.

An enterprise should disclose current investments and non-current investments distinctly in its financial statements. Current investments are shown under ***Current Assets***. Investments other than current investments are classified as non-current investments, even though they may be readily marketable. It is shown in the Balance Sheet under ***Non-current Assets***.

Cost of Investments

The cost of an investment should include acquisition charges such as brokerage, fees and duties. ***For example***, X Limited purchased 1,000 shares @ ₹ 120 each and paid brokerage @ 2%.

The acquisition cost of the investment is as under :	₹
Cost of shares (1,000 × ₹ 120)	1,20,000
Add : Brokerage (2% on ₹ 1,20,000)	2,400
Cost of acquisition	1,22,400

If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair market value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

For example, X Limited acquired 1,000 shares of ₹ 100 each (market value ₹ 130 each) in Y Ltd. by the issue of its 1,000 shares — face value and market value per share being ₹ 100 and ₹ 120 respectively. To ascertain the cost of the investment, in such a case, market value of the shares issued is to be considered. Therefore, the value of the investment is 1,000 × ₹ 120 = ₹ 1,20,000.

If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value (market value or net realisable value) of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

For example, X Limited acquired 1,000 shares of ₹ 100 each (market value ₹ 120 each) in exchange for a machinery (W.D.V. ₹ 90,000 and market value ₹ 1,10,000). The cost of the investment in this case, would be either the fair value of the shares acquired, i.e., ₹ 1,20,000 or the fair value of the machiney given up, i.e., ₹ 1,10,000 — which is more clearly evident.

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

For example, X Limited purchased a flat from a co-operative society for ₹ 20,00,000. To obtain the membership of the society, X Limited had to purchase 1,000 shares of ₹ 100 each. In effect, the cost of acquisition of this investment property becomes ₹ 20,00,000 + ₹ 1,00,000 = ₹ 21,00,000.

Borrowing costs incurred (as per AS—16) in acquiring an investment property should be capitalised and included as an element of cost of an investment property.

Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer (para 23 of AS—13).

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 (para 24 of AS—13). Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the Profit and Loss Account / Statement of Profit and Loss.

Fixed Income Bearing Securities

This type of security carries a fixed rate of income (interest/dividend) and that income accrues regularly but falls due on some specific due date (say, 30th June and 31st December). Investment in government securities, debentures and bonds come under this category. If a company buys 12% Debentures of X Ltd. for ₹ 1,00,000 at par and the due date of payment of interest is 30th June and 31st December, the company is entitled to get ₹ 12,000 (12% of ₹ 1,00,000) interest for one year (12% signifies rate of interest per annum on the face value) — ₹ 6,000 will be due on 30th June and the balance of ₹ 6,000 on 31st December.

Variable Income Bearing Securities

The example of a variable income bearing security is the equity share of a company, the income for an accounting period depends on the rate of dividend declared by that company.

A business can buy or sell securities freely in the stock exchange through brokers, who charge a small commission for their services known as brokerage. It is payable at the time of purchase or sale of those securities. Securities can also be purchased through banks, instead of through brokers. In such cases, a business has to pay a banker's commission in line of brokerage. Both are the same. When securities are purchased, the above expenses become part of the total cost of securities, i.e., the actual cost of securities are added with brokerage or banker's commission (as the case may be) and the stamp duty to arrive at the real cost of the securities. But when the securities are sold, the amount of brokerage or banker's commission is deducted from the sale proceeds realised to ascertain the net realisation from securities.

Securities can be purchased at face value, or at a discount or at a premium. The market prices of securities also fluctuate very frequently for reasons more than one. A security is said to be at par when acquired or sold at a price same as the face value. It is said to be at a discount, when it is sold or acquired at a price lower than its face value. Conversely, if it is above the face value, it is said to be at a premium.

It should be noted that the brokerage is calculated as a percentage of the market value of the investment.

Accounting Arrangements of Fixed Income Bearing Security

In the books of the investing company a separate Investment Account is opened for each security. It is ruled like a ledger account with some additional columns in each side. The format of Investment Account is given below :

In the books of X Ltd.
12% Debentures in ITC Ltd. Account
Dr. [Interest Payable : 30th June & 31st December] Cr.

Date	Particulars	Nominal Value	Interest or Dividend	Cost (₹)	Date	Particulars	Nominal Value	Interest or Dividend	Cost (₹)
(1)	(2)	(3)	(4)	(5)	(1)	(2)	(3)	(4)	(5)

Column 1 : Date of transaction is recorded in this column.
Column 2 : Name of the account to be credited or debited is written in this column with Pre-fix "To" or "By".
Column 3 : It is a memorandum column only. Nominal value of each transaction is recorded in this column either in value or in quantitative terms.
Column 4 : It is a (double entry) income column to record interest or dividend from investment.
Column 5 : It is a (double entry) cost / principal / capital column to record actual cost of investments after adjustment for brokerage, accrued interest, etc.

Purposes of Investment Ledger

Investment ledger is a special type of ledger which is used by the investing company to record all the details of each investment. The main objectives of maintaining on investment ledger are as follows:

(i) It facilitates proper recording of each security separately.
(ii) It facilitates collection of interest and dividend as and when they are due.
(iii) It helps to determine the value of securities at the end of the accounting period.
(iv) It helps to determine the profit or loss on sale of any security.

Sale of Investments

When an investment is sold, the difference between the carrying amount and the disposal proceeds, net of expenses, should be charged or credited to the Profit and Loss Account / Statement of Profit and Loss. When disposing of a part of the holding of an individual investment, the carrying amount is to be allocated to that part is to be determined on the basis of the ***average carrying amount of the total holding of the investment*** (para 22 of AS—13).

Purchase / Sale of Investment on the Date of Payment of Interest

When an investment is purchased / sold on the date of interest, the quotation price contains no interest. Therefore, the allocation of a quoted price between cost and revenue does not arise. The entire quoted price represents the cost of investment.

Journal Entries

1. When investment is purchased at interest date

Investment Account Dr. [(Quoted price + Brokerage) x No. of Investments]
To Bank Account

2. When interest / dividend is received after purchase

Bank Account Dr.
To Interest / Dividend Account

3. When investment is sold at interest date

Bank Account Dr. [(Quoted price – Brokerage) x No. of Investments]
To Investment Account

4. For transfer of interest / dividend to the Profit and Loss Account / Statement of Profit and Loss at the year end

Interest / Dividend Account Dr.
To Profit and Loss Account / Statement of Profit and Loss

5. At the end of the accounting year, the balance of investment is to be valued as follows :

(a) Current investments at cost or fair value, whichever is lower;
(b) Long-term investment at cost (provided no decline is anticipated);
(c) Investment properties at cost.

6. The balance of investment account represents the profit or loss on sale of investment. If it shows a credit balance, there is a profit. The entry will be :

Investment Account Dr.
To Profit and Loss Account / Statement of Profit and Loss

If this account shows a debit balance, there is a loss. The entry will be :

Profit and Loss Account / Statement of Profit and Loss Dr.
To Investment Account

It should be noted that interest / dividend is calculated on nominal / face value of the investment.

Illustration 1

On 1st January, 2016 HP Ltd. purchased 1,000 15% Debentures of Reliance Ltd. of ₹ 100 each @ ₹ 96 each. On 1st July, 2016, half of the Debentures were sold at ₹ 99 each. Debenture interest is payable half-yearly on 30th June and 31st December. You are required to show 15% Debentures in Reliance Ltd. Account in the books of HP Ltd. assuming that the accounting year closes on 31st December. Market price of a debenture as on 31st December is ₹ 98.

Solution

In the books of H.P. Ltd.
15% Debentures in Reliance Ltd. Account
[Interest Payable : 30th June & 31st December]

Dr. **Cr.**

Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)
2016					2016				
Jan. 1	To Bank A/c	1,00,000	—	96,000	Jun 30	By Bank A/c (Note 1)	—	7,500	—
Jul. 1	To Statement of Profit & Loss (Note 2)	—	—	1,500	Jul. 1	By Bank A/c (Note 2)	50,000	—	49,500
					Dec. 31	By Bank A/c (Note 3)	—	3,750	—
Dec. 31	To Statement of Profit & Loss (Note 5)	—	11,250	—	Dec. 31	By Balance c/d (Note 4)	50,000	—	48,000
		1,00,000	11,250	97,500			1,00,000	11,250	97,500

Working Notes :

(1) Interest on 30th June, 2016 will be received @ 15% on ₹ 1,00,000 for 6 months. Interest = ₹ 1,00,000 x 15/100 x 6/12 = ₹ 7,500.

(2) 1/2 of the debentures were sold @ ₹ 99 each. Therefore, sale proceeds will be ₹ 99 x 500 = ₹ 49,500.

Profit on Sale of Investments on 1.7.2016	₹
Sale Proceeds	49,500
Less : Average Cost (₹ 96,000 / 1,00,000 × 50,000)	48,000
Profit on Sale	1,500

(3) Interest on 31st December, 2016 will be received @ 15% on ₹ 50,000 for 6 months. Interest = ₹ 50,000 x 15/100 x 6/12 = ₹ 3,750.

(4) At the end of the year, investment is to be valued on the basis of cost or fair value whichever is less. In this case, fair value is ₹ 98 but cost price is ₹ 96. Therefore, the value of investment on 31st December, 2016 will be ₹ 96 × 500 = ₹ 48,000.

(5) The credit balance of interest column represents interest earned during 2016. It is a revenue income and should be transferred to Profit and Loss Account / Statement of Profit and Loss at the year end. A business which holds many investments may prefer to aggregate the income in a separate account, the balance of which is transferred to Profit and Loss Account / Statement of Profit and Loss.

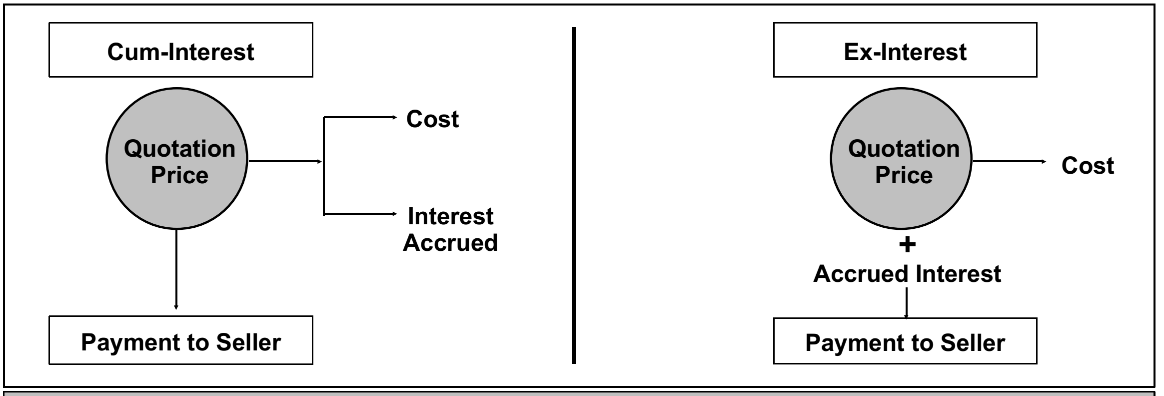
Purchase / Sale of Investment before the Date of Payment of Interest

When investments are purchased or sold before the due date of interest, a problem may arise whether the quotation price includes the interest (upto the date of purchase / sale) or not. The quotation price may be ***ex-interest*** or ***cum-interest***.

Meaning of Cum-interest and Ex-interest

'Cum' and 'Ex' are Latin words. 'Cum' means with and 'Ex' means without. The terms 'Cum-interest' and 'Ex-interest' relate to fixed interest bearing securities and come up for consideration when those securities are purchased or sold. 'Cum-interest' can be expanded as cumulative or inclusive of interest and 'Ex- interest' can be expanded as exclusive of interest. It has already been stated that interest on a fixed interest bearing security accrues on specific due dates. The important point is to note that the holder of the securities is entitled to the whole amount of interest that accrues on the due date irrespective of his period of holding. This is because a company can pay interest only to that person whose name appears in the books of the company as a holder on the date of payment of interest. The quotation, Cum-interest, not only covers the cost but also includes the interest accrued upto the date of purchase; when interest becomes due, it would be the right of the buyer to claim that. Conversely, the quotation, Ex-interest, only covers the cost of the investments and the buyer is liable to pay additional amount as interest accrued upto the date of purchase of investments.

The block diagram given below illustrates the meaning of cum-interest and ex-interest.



In this connection, the following points are important :
(i) In respect of Government securities and debentures, the price quoted is ex-interest unless otherwise stated; and (ii) In respect of Non-Government securities and debentures, it is cum-interest unless otherwise stated.

Cum-interest / Dividend Purchases

When securities are purchased 'Cum-interest' care must be taken at the time of passing entry for purchase. In this case, quotation price consists of ***cost plus accrued interest***. Investment Account will be debited with the ***cost*** only and Interest Account will be debited with accrued interest upto the date of purchase from the date of last interest paid. Bank Account will be credited with the quotation price. On receipt of first amount of interest on due date, the Interest Account will be credited with the ***whole*** amount of that period.

For calculating cost and accrued interest, the following steps should be followed :

Step 1 *:* Calculate the period between the date of last interest paid and the date of purchase of securities.

Step 2 *:* Calculate accrued interest by applying the following formula:

$$\text{Accrued Interest} = \frac{\text{Rate of interest} \times \text{Period (in months)}}{12} \times \text{Face value of securities purchased}$$

Step 3 *:* Calculate cost as follows :

Cost = (Quotation price x No. of securities purchased) *less* accrued interest as calculated in Step 2

Example: On 1st April 2016, X Ltd. purchased 2,000, 12% debentures of ₹ 100 each @ ₹ 98 (cum-interest). Debenture interest is payable half-yearly, on 30th June and 31st December. Date of closing the books of account is 31st December every year. Cost and accrued interest are to be calculated as follows:

Step 1 *:* Calculation of period (in months) From 1.1.2016 to 31.3.2016 = 3 months.

Step 2 *:* Accrued interest = 12% x 3/12 x ₹ 2,00,000 = ₹ 6,000.

Step 3 *:* Cost = (₹ 98 x 2,000) *less* ₹ 6,000 = ₹ 1,96,000 – ₹ 6,000 = ₹ 1,90,000.

Journal Entries

1. When investment is purchased cum-interest

Investment Account	Dr. [Cost]
Interest Account	Dr. [Accrued interest]
To Bank Account	[Quotation price]

2. When first interest is received on due date after purchase

Bank Account	Dr.
To Interest Account	[Whole amount of that period]

Illustration 2

On 31st March, 2016, X Ltd. purchased ₹ 2,00,000 6% Government Stock (face value of ₹ 100 each) at ₹ 95 each cum-interest. Half-yearly interest is payable on 30th June and 31st December every year.

Show entries in the investment ledger of X Ltd. for its financial year ended on 31st December, 2016, ignoring income tax and brokerage.

Solution

On 31st March, 2016 X Ltd. purchased 2,000 stocks (₹ 2,00,000 / 100) @ ₹ 95 cum-interest. Total payment was made ₹ 1,90,000 (₹ 95 × 2,000) which includes interest accrued upto 31st March, 2016 (i.e., for 3 months — January, February and March). The amount of accrued interest = ₹ 2,00,000 × 6/100 × 3/12 = ₹ 3,000. Therefore, cost of investment purchased will be : ₹ 1,90,000 – ₹ 3,000 = ₹ 1,87,000.

On 30th June, 2016 interest will be received @ 6% on ₹ 2,00,000 for the entire 6 months, i.e., 6/100 × ₹ 2,00,000 × 6/12 = ₹ 6,000.

Again on 31st December, 2016 interest will be received @ 6% on ₹ 2,00,000 for 6 months, i.e., 6/100 × ₹ 2,00,000 × 6/12 = ₹ 6,000. Net income from interest = ₹ 6,000 + ₹ 6,000 – ₹ 3,000 = ₹ 9,000 will be credited to Profit and Loss Account / Statement of Profit and Loss.

In the books of X Ltd.
6% Government Stock Account
Dr. **[Interest Payable : 30th June & 31st December]** **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
31.3.16	To Bank A/c	2,00,000	3,000	1,87,000	30.6.16	By Bank A/c	—	6,000	—
31.12.16	To Statement of Profit & Loss	—	9,000	—	31.12.16	By Bank A/c	—	6,000	—
						By Balance c/d	2,00,000	—	1,87,000
		2,00,000	12,000	1,87,000			2,00,000	12,000	1,87,000

In the diagrammatic form, the position is :

Payment of Interest | **Date of Acquisition** | **Payment of Interest**

Cost	Interest					
	January	February	March	April	May	June
Total cost ₹ 1,90,000 (₹ 2,00,000 at ₹ 95) includes interest for January, February and March 2016						
X Ltd. :						
(1) On purchase, debit Interest Account with 3 months accrued interest included in purchase price and debit cost with the balance.	**Debit : Interest Account**					
(2) On receipt of first interest in June, credit Interest Account with the whole amount.	**Credit : Interest Account**					

Ex-interest / Dividend Purchases

When securities are purchased on 'ex-interest', the quotation price consists of no accrued interest. The seller will get quotation price *plus* accrued interest. The Investment Account will be debited with quotation price *plus* brokerage (if any). Interest Account will be debited with accrued interest. Bank Account will be credited with quotation price *plus* accrued interest. On receipt of the first amount of interest, the Interest Account will be credited with whole amount of that period. Accrued interest will be calculated just like in the previous method.

Journal Entries

1. When investment is purchased ex-interest

Investment Account	Dr. [Quotation Price]
Interest Account	Dr. [Accrued interest]
To Bank Account	[Quotation Price *plus* accrued interest]

2. When first interest is received on due date after purchase

Bank Account	Dr.
To Interest Account	[Whole interest of that period]

Illustration 3

On 31st March, 2016, X Ltd. purchased ₹ 2,00,000 6% Government Stock (face value of ₹ 100 each) at ₹ 95 each ex-interest. Half-yearly interest is payable on 30th June and 31st December every year.

Show entries in the investment ledger of X Ltd. for its financial year ended on 31st December, 2016 ignoring income tax and brokerage.

Solution

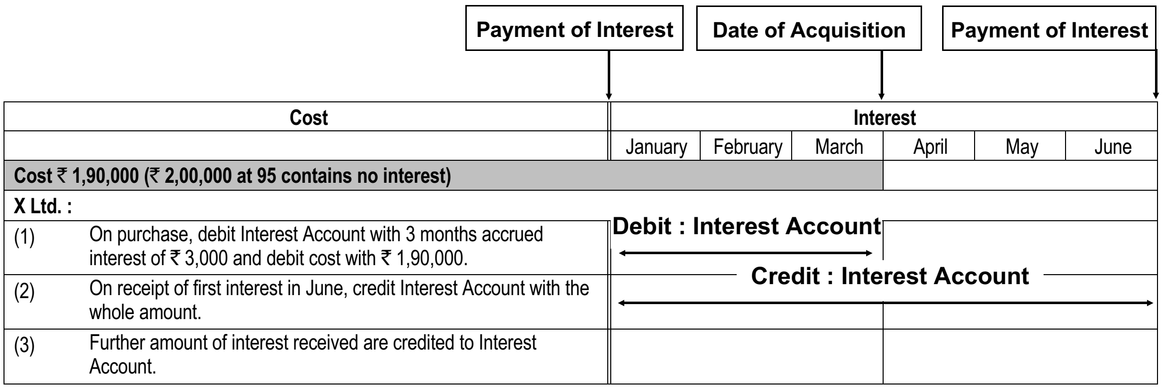
On 31st March, 2016, X Ltd. purchased 2,000 stocks (₹ 2,00,000 / 100) @ ₹ 95 ex-interest. X Ltd. will have to pay ₹ 1,90,000 (₹ 95 × 200) plus accrued interest for 3 months (January, February and March) ₹ 3,000. Therefore, total payment will be ₹ 1,93,000. Investment Account will be debited with ₹ 1,90,000 and Interest Account will be debited with ₹ 3,000. The Bank Account will be credited with ₹ 1,93,000.

On 30th June, 2016, interest will be received on ₹ 2,00,000 for the entire 6 months. Net income from interest ₹ 6,000 + ₹ 6,000 – ₹ 3,000 = ₹ 9,000 will be credited to Profit and Loss Account / Statement of Profit and Loss.

In the books of X Ltd.
6% Government Stock Account
Dr. [Interest Payable : 30th June & 31st December] Cr.

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
31.3.16	To Bank A/c	2,00,000	3,000	1,90,000	30.6.16	By Bank A/c	—	6,000	—
31.12.16	To Statement of Profit & Loss	—	9,000	—	31.12.16	By Bank A/c	—	6,000	—
					31.12.16	By Balance c/d	2,00,000	—	1,90,000
		2,00,000	12,000	1,90,000			2,00,000	12,000	1,90,000

In the diagrammatic form, the position is :



Cum-interest / Dividend Sales

When securities are sold "cum-interest", the sale proceeds consists of accrued interest also. Interest Account will be credited with the accrued interest and the Investment Account will be credited with the balance amount. The Bank Account will be debited with the quotation price.

Journal Entries

1. When investment is sold cum-interest

Bank Account	Dr. [Quotation Price]
To Investment Account	[Quotation Price *less* accrued interest]
To Interest Account	[Accrued interest]

2. At the end of the year, profit/loss on sale of investment is transferred to Profit and Loss Account / Statement of Profit and Loss

If there is a profit on sale of investment

Investment Account Dr.
To Profit and Loss Account / Statement of Profit and Loss

If there is a loss on sale of investment

Profit and Loss Account / Statement of Profit and Loss Dr.
To Investment Account

It should be noted that any brokerage on sale of investment paid should be deducted from sale proceeds to get net sale proceeds.

Illustration 4

On 1st April, 2016 Janaki Ltd. had ₹ 3,00,000 6% Government Stock at ₹ 94 each (face value ₹ 100). Interest is payable half-yearly on 31st March and 30th September. The company sold ₹ 90,000 of the stock at ₹ 95 cum-interest on 1st June,

2016. Draw up 6% Government Stock Account in the Investment Ledger of the company for the year ended 31st March 2017. Ignore brokerage and income tax. The stock was quoted at ₹ 96 ex-interest at the stock exchange on that date.

Solution

On 1st June, 2016 6% Government stock of ₹ 90,000 was sold @ ₹ 95 each cum-interest. Total amount received ₹ 85,500 (₹ 95 × 900) which includes ₹ 900 (₹ 90,000 × 6/100 × 2/12) accrued interest for 2 months April and May. Therefore, net sale proceeds ₹ 85,500 – ₹ 900 = ₹ 84,600 will be credited to Investment Account and ₹ 900 will be credited to Interest Account.

On 30th September, 2016, interest will be received on ₹ 2,10,000 (₹ 3,00,000 – ₹ 90,000) for 6 months. Interest = ₹ 2,10,000 × 6/100 × 6/12 = ₹ 6,300.

On 31st March, 2017, interest will be received on ₹ 2,10,000 for 6 months. Interest = ₹ 2,10,000 × 6/100 × 6/12 = ₹ 6,300.

On 31st March, 2017, the stock of ₹ 2,10,000 will be valued @ ₹ 94 each (because cost is less than market price of ₹ 96). Therefore, the value of stock will be = ₹ 94 × 2,100 = ₹ 1,97,400.

In the books of Janaki Ltd.
6% Government Stock Account
Dr. [Interest Payable : 31st March and 30th September] Cr.

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.4.16	To Balance b/d	3,00,000	—	2,82,000	1.6.16	By Bank A/c	90,000	900	84,600
31.3.17	To Statement of Profit & Loss	—	13,500	—	30.9.16	By Bank A/c	—	6,300	—
					31.3.17	By Bank A/c	—	6,300	—
					31.3.17	By Balance c/d	2,10,000	—	1,97,400
		3,00,000	13,500	2,82,000			3,00,000	13,500	2,82,000

In the diagramatic form, the position is :

Payment of Interest | **Date of Acquisition** | **Payment of Interest**

Cost	Interest					
	April	May	June	July	August	Sept.
Total proceeds of ₹ 85,500 (₹ 95 x 900) includes interest for April & May						
Janaki Ltd. :						
(1) On sale, credit Interest Account with 2 months accrued interest including in sale proceeds and credit Investment Account with the balance.	**Credit : Interest Account**					

Ex-interest / Dividend Sales

When securities are sold ex-interest, Quotation price excludes accrued interest. Investment Account will be credited with the Quotation price and Interest Account will be credited with accrued interest. The Bank Account will be debited with Quotation price *plus* accrued interest upto the date of sale.

Journal Entries

1. When investment is sold ex-interest

Bank Account	Dr. [Quotation price *plus* accrued interest]
To Investment Account	[Quotation price]
To Interest Account	[Accrued interest]

2. At the end of the year, profit/loss on sale of investment is transferred to Profit and Loss Account / Statement of Profit and Loss

If there is a profit on sale of investment

Investment Account Dr.
To Profit and Loss Account / Statement of Profit and Loss

If there is a loss on sale of investment

Profit and Loss Account / Statement of Profit and Loss Dr.
To Investment Account

Illustration 5

On 1st April, 2016 Janaki Ltd. had current investment of ₹ 3,00,000 6% Government stock at ₹ 94 (face value ₹ 100). Interest is payable half-yearly on 31st March and 30th September. The company sold ₹ 90,000 of the stock at ₹ 95 ex-interest on 1st June, 2016. Draw up 6% Government Stock Account in the Investment Ledger of the company for the year ended 31st March, 2017. Ignore brokerage and income tax. The stock was quoted at ₹ 96 ex-interest at the stock exchange on that date.

Solution

On 1st June, 2016, 6% Government Stock of ₹ 90,000 was sold @ ₹ 95 ex-interest. This price of ₹ 95 excludes accrued interest for April and May. Total accrued interest = ₹ 90,000 × 6/100 × 2/12 = ₹ 900. Amount will be received from the buyer (₹ 95 × 900) + ₹ 900 = ₹ 86,400. Interest Account will be credited with ₹ 900 and Investment Account will be credited with ₹ 85,500. The Bank Account will be debited with ₹ 86,400.

Profit on Sale of ₹ 90,000 Stock on 1.6.2016	₹
Sale Proceeds	85,500
Less: Average Cost (₹ 2,82,000 / 3,00,000 × 90,000)	84,600
Profit on Sale	900

On 30th September, 2016 interest will be received on ₹ 2,10,000 (₹ 3,00,000 – ₹ 90,000) for 6 months. Interest = ₹ 2,10,000 × 6/100 × 6/12 = ₹ 6,300.

On 31st March, 2017, interest will be received on ₹ 2,10,000 for 6 months. Interest = ₹ 2,10,000 × 6/100 × 6/12 = ₹ 6,300.

On 31st March, 2017, the stock of ₹ 2,10,000 will be valued @ ₹ 94 each (because cost is less than market price of ₹ 96). Therefore, the value of stock will be ₹ 94 × 2,100 = ₹ 1,97,400.

In the books of Janaki Ltd.
6% Government Stock Account
[Interest Payable : 31st March and 30th September]

Dr. **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.4.16	To Balance b/d	3,00,000	—	2,82,000	1.6.16	By Bank A/c	90,000	900	85,500
1.6.16	To Statement of Profit & Loss	—	—	900	30.9.16	By Bank A/c	—	6,300	—
					31.3.17	By Bank A/c	—	6,300	—
		3,00,000	13,500	2,82,900			3,00,000	13,500	2,82,900

In the diagrammatic form, the position is :

Payment of Interest **Date of Acquisition** **Payment of Interest**

Cost		**Interest**					
		April	May	June	July	August	Sept.
Proceeds of ₹ 85,500 excludes interest for April & May							
Janaki Ltd. :							
(1)	On sale, credit Interest Account with 2 months accrued interest of ₹ 900. ₹ 85,500 will be credited to Investment Account.	**Credit : Interest Account**					

Illustration 6

On 1.1.2016, 200, 6% debentures of ₹ 100 each of Y Ltd. were held as investments by X Ltd. at a cost of ₹ 18,200. Interest is payable on December 31.

On 1.4.2016 : ₹ 4,000 of such debentures were purchased by X Ltd. @ ₹ 98 each cum-interest.

On 1.9.2016 : ₹ 6,000 debentures were sold at ₹ 96 ex-interest.

On 1.12.2016 : ₹ 8,000 debentures were sold @ ₹ 99 cum-interest.

On 31.12.2016 : X Ltd. sold ₹ 10,000 debentures @ ₹ 95 cum-interest.

Prepare the Investment Account for 6% debentures of Y Ltd. in the books of X Ltd. Ignore income tax.

Solution

In the books of X Ltd.
6% Debentures in Y Ltd. Account
[Interest Payable : 31st December]

Dr. **Cr.**

Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)
1.1.16	To Balance b/d	20,000	—	18,200	1.9.16	By Bank A/c (Note 2)	6,000	240	5,760
1.1.16	To Bank A/c (Note 1)	4,000	60	3,860	1.12.16	By Bank A/c (Note 3)	8,000	440	7,480
1.9.16	To Statement of Profit & Loss (Note 2)	—	—	245	31.12.16	By Bank A/c (Note 4)	10,000	600	8,900
1.12.16	To Statement of Profit & Loss (Note 3)	—	—	127	31.12.16	By Statement of Profit & Loss (Note 4)	—	—	292
31.12.16	To Statement of Profit & Loss (transfer)	—	1,220	—					
		24,000	1,280	22,432			24,000	1,280	22,432

Working Notes :

(1) On 1.4.16, 40 debentures were purchased @ ₹ 98 cum-interest. It means that the total payment of ₹ 3,920 (40 × ₹ 98) includes interest accrued upto 31.3.16. The amount of accrued interest = ₹ 4,000 × 6/100 × 3/12 = ₹ 60. Therefore, cost of investment purchased = ₹ 3,920 – ₹ 60 = ₹ 3,860.

(2) On 1.9.16, 60 Debentures were sold @ ₹ 98 ex-interest. It means that ₹ 5,760 (₹ 98 × 60) will be received for sale of investment and in addition ₹ 240 (₹ 6,000 × 6/100 × 8/12) will be received for interest of 8 months.

Profit on sale of 60 Debentures	₹
Sale proceeds	5,760
Less: Average Cost : $\frac{18,200 + 3,860}{200 + 40} \times 60$ = ₹ 91.92 × 60	5,515
Profit on Sale	245

(3) On 1.12.16, 80 debentures were sold @ ₹ 99 cum-interest. It means that sale proceeds of ₹ 7,920 (₹ 99 × 80) includes accrued interest of ₹ 440 (₹ 8,000 × 6/100 × 11/12). Therefore, amount received on sale of investment = ₹ 7,920 – ₹ 440 = ₹ 7,480.

Profit on Sale of 80 Debentures	₹
Sale proceeds	7,480
Less: Average cost : ₹ 91.92 × 80 (See Note 2)	7,353
Profit on Sale	127

(4) On 31.12.16, debentures were sold @ ₹ 95 cum-interest. It means that the sale proceeds of ₹ 9,500 (₹ 95 × 100) includes interest of ₹ 600 (₹ 10,000 × 6/100 × 12/12). Therefore, amount received on sale of investment = ₹ 9,500 – ₹ 600 = ₹ 8,900.

Loss on Sale of 100 Debentures	₹
Sale Proceeds	8,900
Less: Aveage Cost : ₹ 91.92 × 100	9,192
Loss on Sale	292

Illustration 7

On 1st January 2016, X Ltd. held as investment ₹ 50,000, 6% Government stock costing ₹ 47,000 (face value ₹ 100 each). On 31st March, a purchase of ₹ 2,00,000 same Government stock was made at ₹ 95 cum-interest.

On 1st July, the company sold ₹ 1,00,000 stock @ ₹ 96. On 1st October, a further ₹ 70,000 of the investment was sold at ₹ 98 cum-interest. The market price of the stock on 31.12.2016 was ₹ 99 (ex-interest).

Half-yearly interest is payable on 30th June and 31st December every year. Prepare the Investment Ledger of the company ignoring income tax and brokerage.

Solution

In the books of X Ltd.
6% Government Stock Account
[Interest Payable : 30th June & 31st December]

Dr. **Cr.**

Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)
1.1.16	To Balance b/d	50,000	—	47,000	30.6.16	By Bank A/c (Note 2)	—	7,500	—
31.3.16	To Bank A/c (Note 1)	2,00,000	3,000	1,87,000	1.7.16	By Bank A/c (Note 3)	1,00,000	—	96,000

1.7.16	To Statement of Profit & Loss (Note 3)	—	—	2,400	1.10.16	By Bank A/c (Note 4)	70,000	1,050	67,550
					31.12.16	By Bank A/c (Note 5)	—	2,400	—
1.10.16	To Statement of Profit & Loss (Note 4)	—	—	2,030	31.12.16	By Balance c/d (N 6)	80,000	—	74,880
		—	—						
31.12.16	To Statement of Profit & Loss	—	7,950	—					
		2,50,000	10,950	2,38,430			2,50,000	10,950	2,38,430

Working Notes :

(1) On 31.3.2016, ₹ 2,00,000 stocks were purchased @ ₹ 95 cum-interest. It means that the total payment of ₹ 1,90,000 (₹ 95 × 2,000) includes interest accrued upto 31.3.2016. The amount of accrued interest = ₹ 2,00,000 × 6/100 × 3/12 = ₹ 3,000. Therefore, cost of investment purchased will be ₹ 1,90,000 – ₹ 3,000 = ₹ 1,87,000.

(2) On 30.6.2016, interest will be received on entire stock holding on that date including new purchases for 6 months. The amount of interest = ₹ 2,50,000 × 6/100 × 6/12 = ₹ 7,500.

(3) On 1.7.2016, the sale of stock for ₹ 96,000 does not involve any accrued interest.

Profit on sale of face value of ₹ 1,00,000 on 1.7.2016	₹
Sale proceeds	96,000
Less: Average Cost :	
$\frac{47{,}000 + 1{,}87{,}000}{50{,}000 + 2{,}00{,}000} \times$ ₹ 1,00,000 = ₹ 0.936 × ₹ 1,00,000	93,600
Profit on Sale	2,400

(4) On 1.10.2016, ₹ 70,000 of the investment was sold at ₹ 98 cum-interest. It means that the sale proceeds of ₹ 68,600 (₹ 98 × 700) includes accrued interest for 3 months ₹ 1,050 (₹ 70,000 × 6/100 × 3/12). Therefore, amount received on sale of investment = ₹ 68,600 – ₹ 1,050 = ₹ 67,550.

Profit on sale of 700 Govt. Stock (face value of ₹ 70,000) on 1.10.2016	₹
Sale proceeds	67,550
Less: Average Cost : 0.936 × ₹ 70,000	65,520
Profit on Sale	2,030

(5) Interest for 6 months on ₹ 80,000 will be ₹ 80,000 × 6/100 × 6/12 = ₹ **2,400**.

(6) Balance of face value of ₹ 80,000 = 0.936 × ₹ 80,000 = ₹ **74,880**.

Illustration 8

On 15th March, 2016 O.P. Ltd. purchased ₹ 1,00,000, 9% Government Stock (interest payable on 1st April, 1st July, 1st October and 1st January) at ₹ 88.50 cum-interest (face value ₹ 100 each).

On 1st August, ₹ 20,000 stock is sold at ₹ 89 cum-interest and on 1st September ₹ 30,000 stock is sold at ₹ 89.25 ex-interest. On 31st December, the date of the Balance Sheet, the market price was ₹ 90.

Show the Ledger Account of the investment for the year ignoring income tax, brokerage, etc. (Assume that investments are current investments.)

Solution

In the books of O.P. Ltd.
9% Government Stock Account
Dr. [Interest Payable : 1st April; 1st July; 1st October and 1st January] Cr.

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
15.3.16	To Bank A/c (Note 1)	1,00,000	1,875	86,625	1.4.16	By Bank A/c (Note 2)	—	2,250	—
1.8.16	To Statement of Profit & Loss (Note 4)	—	—	325	1.7.16	By Bank A/c (Note 3)	—	2,250	—
					1.8.16	By Bank A/c (Note 4)	20,000	150	17,650
1.9.16	To Statement of Profit & Loss (Note 5)	—	—	788	1.9.16	By Bank A/c (Note 5)	30,000	450	26,775
					1.10.16	By Bank A/c (note 6)	—	1,125	—
31.12.16	To Statement of Profit & Loss	—	5,475	—	31.12.16	By Balance c/d (N 7)	50,000	1,125	43,313
		1,00,000	7,350	87,738			1,00,000	7,350	87,738

Working Notes :

(1) On 15th March, 1,000 stocks were purchased @ ₹ 88.50 cum-interest. It means that total payment of ₹ 88,500 (₹ 88.50 × 1,000) includes interest accrued upto 15th March. The amount of accrued interest = ₹ 1,00,000 × 9/100 × 2.5/12 = ₹ 1,875. Therefore, cost of investment purchased = ₹ 88,500 – ₹ 1,875 = ₹ 86,625.

(2) On 1st April, interest will be received for 3 months (January, February and March) on ₹ 1,00,000. Therefore, the amount of interest will be ₹ 1,00,000 × 9/100 × 3/12 = ₹ 2,250.

(3) On 1st July, interest will be received for 3 months (April, May and June) on ₹ 1,00,000. Therefore, the amount of interest will be ₹ 1,00,000 × 9/100 × 3/12 = ₹ 2,250.

(4) On 1st August, 200 stocks were sold @ ₹ 89 cum-interest. It means that sale proceeds of ₹ 17,800 (₹ 89 × 200) includes accrued interest for July ₹ 150 (₹ 20,000 × 9/100 × 1/12). Therefore, amount received for sale of investment ₹ 17,800 – ₹ 150 = ₹ 17,650.

Profit on Sale of ₹ 20,000 Stock on 1.8.2016	₹
Sale Proceeds	17,650
Less: Average Cost (₹ 86,625 / 1,00,000 × 20,000)	17,325
Profit on Sale	325

(5) On 1st September, 300 stocks were sold @ ₹ 89.25 ex-interest. It means ₹ 26,775 (₹ 89.25 × 300) will be received for sale of investment and in addition ₹ 450 (₹ 30,000 × 9/100 × 2/12) will be received for interest.

Profit on Sale of ₹ 30,000 Stock on 1.9.2016	₹
Sale Proceeds	26,775
Less: Average Cost (₹ 86,625 / 1,00,000 × 30,000)	25,987
Profit on Sale	788

(6) On 1st October, interest will be received for 3 months (July, August and September) on ₹ 50,000. Therefore, the amount of interest will be ₹ 50,000 × 9/100 × 3/12 = ₹ 1,125.

(7) Stock will be valued on 31st December on the basis of cost or fair value whichever is lower. In this case fair value (market price) of 500 stock is ₹ 45,000 (500 × ₹ 90), but cost of such investment as on that date is ₹ 43,313 (₹ 86,625 / ₹ 1,00,000 × ₹ 50,000). Therefore, the value of stock will be ₹ 43,313 (being lower of the two).
Accrued interest on 31st December will be ₹ 1,125 (₹ 50,000 × 9/100 × 3/12).

Illustration 9

Mrs. Bhakat furnishes the details of her holding in 6% Govt. Bonds :

1.1.2016 Opening balance — face value ₹ 60,000 – cost ₹ 59,000.
1.3.2016 Purchased 100 units ex-interest at ₹ 98.
1.7.2016 Sold 200 units ex-interest at ₹ 100.
1.10.2016 Purchased 50 units at ₹ 98 cum-interest.
1.11.2016 Sold 200 units ex-interest at ₹ 99.

Mrs. Bhakat closes her books every December, 31 and interest dates at March 31 and September 30.
Show the Investment Account in the books of Mrs. Bhakat.

Solution

In the books of Mrs. Bhakat
6% Government Stock Account
Dr. [Interest Payable : 31st March & 30th September] Cr.

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.1.16	To Balance b/d (Note 1)	60,000	900	59,000	31.3.16	By Bank A/c (Note 3)	—	2,100	—
1.3.16	To Bank A/c (Note 2)	10,000	250	9,800	1.7.16	By Bank A/c (Note 4)	20,000	300	20,000
1.7.16	To Statement of Profit & Loss (Note 5)	—	—	343	30.9.16	By Bank A/c (Interest)	—	1,500	—
					1.11.16	By Bank A/c (Note 6)	20,000	100	19,800
1.10.16	To Bank A/c (Note 6)	5,000	—	4,900	31.12.16	By Balance c/d	35,000	525	34,391
1.11.16	To Statement of Profit & Loss (Note 7)	—	—	148					
31.12.16	To Statement of Profit & Loss	—	3,375	—					
		75,000	4,525	74,191			75,000	4,525	74,191

Working Notes :

(1) Date of interest is 31st March and 30th September. Last interest was paid on 30th September, 2015. On 1.1.2016, accrued interest = ₹ 60,000 × 6/100 × 3/12 = ₹ 900.

(2) Accrued interest on the date of purchase = ₹ 10,000 × 6/100 × 5/12 = ₹ 250.

(3) Total interest received = ₹ 70,000 × 6% × 1/2 = 2,100.

(4) Interest accrued = ₹ 20,000 × 6/100 × 3/12 = ₹ 300.

(5) **Profit on Sale of 20,000 Bonds on 1.7.2016**

	₹
Sale proceeds	20,000
Less: Average Cost (68,800 / 70,000 × 20,000)	19,657
Profit on Sale	343

(6) On 1st November, 200 bonds were sold @ ₹ 99 ex-interest. It means ₹ 19,800 will be received for sale of investment and in addition ₹ 100 (20,000 × 6/100 × 1/12) will be received for interest.

Profit on Sale of 20,000 bonds on 1.11.2016

Sale proceeds	19,800
Less: Average Cost (54,043 / 55,000 × 20,000)	19,652
	148

(7) **Accrued Interest on 31.12.2016** = ₹ 35,000 × 6/100 × 3/12 = ₹ **525**.

Illustration 10

On 1st April, 2016 Janaki Ltd. had ₹ 3,00,000 6% Government stock at ₹ 94 (face value ₹ 100 each). Interest is payable half-yearly on 31st March and 30th September. The company sold ₹ 90,000 of the stock at ₹ 95 ex-interest on 1st June and purchased ₹ 72,000 stock at ₹ 97 cum-interest on 1st September. A further purchase of ₹ 36,000 stock was made on 1st December at ₹ 98 ex-interest.

Draw up 6% Government Stock Account in the Investment Ledger of the company for the year ended 31st March, 2017. Ignore brokerage and income tax.

The stock was quoted at ₹ 96 at the Stock Exchange on that date.

Solution

In the books of Janaki Ltd.
6% Government Stock Account
[Interest Payable : 31st March & 30th September]

Dr. **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.4.16	To Balance b/d	3,00,000	—	2,82,000	1.6.16	By Bank A/c (Note 1)	90,000	900	85,500
1.6.16	To Statement of Profit & Loss (Note 1)	—	—	900	30.9.16	By Bank A/c (Note 3)	—	8,460	—
					31.3.17	By Bank A/c (Note 5)	—	9,540	—
1.9.16	To Bank A/c (Note 2)	72,000	1,800	68,040	31.3.17	By Balance c/d	3,18,000	—	3,00,720
1.12.16	To Bank A/c (Note 4)	36,000	360	35,280					
31.3.17	To Statement of Profit & Loss	—	16,740	—					
		4,12,000	18,900	3,86,220			4,12,000	18,900	3,86,220

Working Notes :

(1) Profit on Sale of Stock (ex-interest) on 1.6.2016	₹
Sale proceeds (900 x ₹ 95)	85,500
Less: Average Cost : (₹ 2,82,000 / 3,00,000 x 90,000)	84,600
Profit on Sale	900
Accrued int. receivable in addition (₹ 90,000 x 6/100 x 2/12) = ₹ 900	

(2) Purchase of Stock (cum - interest) on 1.9.2016	
Nominal Value	72,000
Total amount paid (720 x ₹ 97)	69,840
Less : Accrued interest for 5 months (₹ 72,000 x 6/100 x 5/12)	1,800
Cost	68,040

(3) Interest for 6 months ending on 30.9.2016	₹
Interest will be received for 6 months on entire stock holding on that date : (₹ 2,82,000 x 6/100 x 6/12)	8,460

(4) Purchase of Stock (ex - int) on 1.12.2016	
Nominal Value	36,000
Cost (360 x ₹ 98)	35,280
Accrued interest payable in addition for 2 months : (₹ 36,000 x 6/100 x 2/12)	360

(5) Interest for 6 months ending on 31.3.2017	
Interest will be received for 6 months on entire stock holding on that date : (₹ 3,18,000 x 6/100 x 6/12)	9,540

Illustration 11

On 1st March, 2016, XY Corporation Ltd purchased ₹ 30,000, 5% Government stock at ₹ 95 cum-interest. On 1st May, 2016 the company sold ₹ 10,000 of stock at ₹ 97 cum-interest.

On 15th December, 2016, another ₹ 10,000 stock was sold at ₹ 93 ex-interest.

On 31st December, 2016, the closing date of the financial year, the fair value of the stock was ₹ 92.

Half-yearly interest is received every year as on 30th June and 31st December.

Prepare a ledger account in the investment ledger assuming that the stock transfer book is closed 20 days before the date of payment of interest.

Assume investments are current investments.

Solution

In the books of XY Corporation Ltd.
5% Government Stock Account
[Interest Payable : 30th June & 31st December]

Dr. **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.3.16	To Bank A/c (Note 1)	30,000	250	28,250	1.5.16	By Bank A/c (Note 2)	10,000	167	9,533
1.5.16	To Statement of Profit & Loss (Note 2)	—	—	117	30.6.16	By Bank A/c (Interest)	—	500	—
					15.12.16	By Bank A/c (Note 3)	10,000	229	9,300
31.12.16	To Statement of Profit & Loss	—	896	—	"	By Statement of Profit & Loss (Note 5)	—	—	116
					31.12.16	By Bank A/c (Interest)	—	250	—
					31.12.16	By Statement of Profit & Loss	—	—	218
					31.12.16	By Balance c/d (N 4)	10,000	—	9,200
		30,000	1,146	28,367			30,000	1,146	28,367

Working Notes :

(1) Purchase of Stock (cum-interest) on 1.3.2016	₹
Nominal Value	30,000
Total amount paid (300 x ₹ 95)	28,500
Less: Accrued Interest for 2 months (30,000 x 5/100 x 2/12)	250
Cost	28,250

(2) Sale of Stock (cum-interest) on 1.5.2016	₹
Nominal Value	10,000
Sales Proceeds (100 x ₹ 97)	9,700
Less: Accrued Interest for 4 months (10,000 x 5/120 x 4/12)	167
	9,533
Profit on Sale of ₹ 10,000 Stock on 1.5.2016	
Sale Proceeds	9,533
Less: Average Cost (₹ 28,250 / 30,000 x 10,000)	9,416
Profit on Sale	117

(3) Sale of Stock (ex-interest) on 15.12.2016	
Nominal Value	10,000
Sale Proceeds (100 x ₹ 93)	9,300
Accrued Interest for $5^1/_2$ months (10,000 x 5/100 x 11/24)	229

(5) Loss on Sale of ₹ 10,000 Stock on 15.12.2016	
Sale Proceeds	9,300
Less: Average Cost (₹ 2,82,000 / 3,00,000 x 90,000)	9,416
Loss on Sale	116

(4) Cost of Stock on 31.12.2016	₹
(i) Cost Price (28,250 / 30,000 x 10,000)	9,416
(ii) Fair Value (100 x ₹ 92)	9,200
Value of Stock will be ₹ 9,200 (being lower than cost price)	

Illustration 12

M.N. Ltd. bought and sold 6% Stock as follows, interest being payable on 31st March and 30th September each year :

2016

March 1 Bought ₹ 24,000 @ ₹ 90.875 ex-interest, brokerage ₹ 30

June 15 Sold ₹ 10,000 @ ₹ 92.625 cum-interest, brokerage ₹ 13

Aug. 1 Bought ₹ 6,000 @ ₹ 91.375 ex-interest, brokerage ₹ 8

Sept. 1 Sold ₹ 4,000 @ ₹ 93.125 ex-interest, brokerage ₹ 5

Dec. 1 Bought ₹ 12,000 @ ₹ 94.125 cum-interest, brokerage ₹ 15

Prepare Investment Account for the year ended 31st December 2016. [Detailed workings are to be given].

Solution

In the books of MN Ltd.
6% Stock Account
[Interest Payable : 31st March & 30th September]

Dr. **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.3.16	To Bank A/c (Note 1)	24,000	600	21,840	31.3.16	By Bank A/c (Note 2)	—	720	—
15.6.16	To Statement of Profit & Loss (Note 2)	—	—	25	15.6.16	By Bank A/c (Note 3)	10,000	125	9,125
					1.9.16	By Bank A/c (Note 5)	4,000	100	3,720
1.8.16	To Bank A/c (Note 4)	6,000	120	5,490	30.9.16	By Bank A/c (Note 6)	—	480	—
1.9.16	To Statement of Profit & Loss (Note 5)	—	—	74	31.12.16	By Balance c/d (Note 8)	28,000	420	25,774
1.12.16	To Bank A/c (Note 7)	12.000	120	11,190					
31.12.16	To Statement of Profit & Loss	—	1,005	—					
		42,000	1,845	38,619			42,000	1,845	38,619

Working Notes : **(1) Purchase of Stock (ex-interest) on 1.3.2016**	₹	**(2) Interest for 6 months ending on 31.3.2016**	₹
Nominal Value	24,000	Interest will be received for 6 months on entire stock	
Cost (₹ 24,000 x 0.90875)	21,810	(₹ 24,000 x 6/100 x 6/12)	720
Add : Brokerage	30	**(3) Sale of Stock (cum-interest) on 15.3.2016**	
Total Cost	21,840	Nominal Value	10,000
Accrued interest payable in addition for 5 months =		Sale proceeds (₹ 10,000 x 0.92625)	9,263
(₹ 24,000 x 6/100 x 5/12) =	600	Less : Accrued interest including therein	
(4) Purchase of stock (ex - interest) on 1.8.2016		(₹ 10,000 x 6/100 x 2.5/12)	125
Nominal Value	6,000		9,138
Cost (₹ 6,000 x 0.91375)	5,482	Less : Brokerage	13
Add : Brokerage	8	**Effective sale proceeds**	9,125
Total Cost	5,490	**Profit on Sale of ₹ 10,000 stock on 15.06.2016**	
Accrued interest payable in additition for 4 months		Sale Proceeds	9,125
(₹ 6,000 x 6/100 x 4/12)	120	Less: Average cost : $\frac{21,840}{24,000} \times$ ₹ 10,000	
(6) Interest for 6 months ending on 30.9. 2016		= 0.91 x ₹ 10,000	9,100
Interest will be received on (₹ 24,000 + ₹ 6,000 –		**Profit on Sale**	25
₹ 10,000 – ₹ 4,000) = ₹ 16,000 for 6 months. Therefore, interest = ₹ 16,000 x 6/100 x 6/12 = ₹ 480.		Closing value = $\frac{21,840}{24,000} \times$ ₹ 14,000 = ₹ 12,740.	
(7) Purchase of Stock (cum-interest) on 1.12.2016		(5) Sale of Stock (ex-interest) on 1.9.2016	
Nominal Value	12,000	Nominal Value	4,000
Cost (₹ 12,000 x 0.94125)	11,295	Sale proceeds (₹ 4,000 x 0.93125)	3725
Less : Accrued interest included (₹ 12,000 x 6/100 x 2/12)	120	Less : Brokerage	5
	11,175	**Efffective sale proceeds**	3,720
Add: Brokerage	15	Accrued interest receivable in addition :	
	11,190	(₹ 4,000 x 6/100 x 5/12) =	100
(8) Accrued Interest to be carried forward		Profit on Sale of ₹ 4,000 stock on 1.09.2016	
₹ 28,000 x 6/100 x 3/12	420	Sale Proceeds	3,720
Balance of Investment on 31.12.2016		Less: Average cost :	
₹ 14,584 + ₹ 11,190	25,774	$\frac{12,740 + 5,490}{14,000 + 6,000} \times$ ₹ 4,000	3,646
		Profit on Sale	74
		Closing value = $\frac{12,740 + 5,490}{14,000 + 6,000} \times$ ₹ 16,000 = ₹ 14,584.	

Illustration 13

Jaipur Investments Ltd. hold 1,000 15% debentures of ₹ 100 each in Udaipur Industries Ltd. as on April 1, 2016 at a cost of ₹ 1,05,000.

Interest is payable on June 30 and December 31 each year.

On May 1, 2016, 500 debentures are purchased cum-interest at ₹ 53,500.

On November 1, 2016, 600 debentures are sold ex- interest at ₹ 57,300.

On November 30, 2016, 400 debentures are purchased ex-interest at ₹ 38,400.

On December 31, 2016, 400 debentures are sold cum-interest for ₹ 55,000.

Prepare the Investment Account upto March 31, 2017.

Solution

In the books of Jaipur Investments Ltd.
15% Debentures in Udaipur Industries Ltd. Account
[Interest Payable : 30th June & 31st December]

Dr. **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.4.16	To Balance b/d (N 1)	1,00,000	3,750	1,05,000	30.6.16	By Bank A/c (Note 3)	—	11,250	—
1.5.16	To Bank A/c (Note 2)	50,000	2,500	51,000	1.16.16	By Bank A/c (Note 4)	60,000	3,000	57,300
30.11.16	To Bank A/c (Note 5)	40,000	2,500	38,400	1.11.16	By Statement of Profit & Loss (Note 4)	—	—	5,100
31.12.16	To Statement of Profit & Loss (Note 6)	—	—	11,385	31.12.16	By Bank A/c (Note 6)	40,000	3,000	52,000
31.3.17	To Statement of Profit & Loss	—	18,625	—	"	By Bank A/c (Note 7)	—	6,750	—
					31.3.17	By Balance c/d (N 8)	90,000	3,375	91,385
		1,90,000	27,375	2,05,785			1,90,000	27,375	2,05,785

Working Notes :

(1) Opening balance of ₹ 3,750 in interest column represents accrued interest for 3 months (Jan + Feb + March). Accrued interest = ₹ 1,00,000 × 15/100 × 3/12 = ₹ 3,750.

(2) On 1st May, 2016, 500 debentures were purchased cum-interest. It means that the total payment of ₹ 53,500 includes interest accrued upto 30th April, 2016. The amount of accrued interest = ₹ 50,000 × 15/100 × 4/12 = ₹ 2,500. Therefore, cost of investment will be: ₹ 53,500 – ₹ 2,500 = ₹ 51,000.

(3) On 30th June 2016, interest will be received on entire debentures holding on that date including new purchase for 6 months. The amount of interest = ₹ 1,50,000 × 15/100 × 6/12 = ₹ 11,250.

(4) On 1st November 2016, 600 debentures were sold ex-interest at ₹ 57,300. It means that the accrued interest of ₹ 3,000 (₹ 60,000 × 15/100 × 4/12) were also received in addition to ₹ 57,300.

Loss on Sale of 600 debentures on 1.11.2016	₹
Sale proceeds	57,300
Less: Average Cost : $\frac{1,05,000 + 51,000}{1,000 + 500} \times 600 = ₹\ 104 \times 600$	62,400
Loss on Sale	5,100

Closing value of 900 debentures = ₹ 104 × 900 = ₹ **93,600**.

(5) On 30th November 2016, 400 debentures were purchased ex-interest at ₹ 38,400. It means that the accrued interest of ₹ 2,500 (₹ 40,000 × 15/100 × 5/12) were also paid in addition to ₹ 38,400.

(6) On 31st December 2016, 400 debentures were sold cum-interest at ₹ 55,000. It means that the accrued interest of ₹ 3,000 (₹ 40,000 × 15/100 × 6/12) were received, which is included in ₹ 55,000. Therefore, the effective sale proceeds is ₹ 55,000 – ₹ 3,000 = ₹ 52,000.

Profit on sale of 400 debentures on 31.12.16	₹
Sale proceeds	52,000
Less: Average Cost : $\frac{93,600 + 38,400}{900 + 400} \times 400 = ₹\ 101.51 \times 400$	40,615
Profit on Sale	11,385

(7) On 31st December 2016, interest will be received on entire debentures holding on that date i.e., ₹ 90,000. Interest for 6 months = (₹ 90,000 × 15/100 × 6/12) = ₹ 6,750.

(8) On 31st March 2017, accrued interest will be for 3 months = ₹ 90,000 × 15/100 × 3/12 = ₹ 3,375. Balance of investment on 31st March, 2017 = ₹ 101.54 × 900 = ₹ 91,385.

Illustration 14

Mr. Investor furnishes the following details relating to his holding in 6% Government Bonds.

1.1.2016 Opening balance face value ₹ 60,000 – Cost ₹ 59,000
1.3.2016 100 units purchased ex-interest at ₹ 98
1.7.2016 Sold 200 units ex-interest at ₹ 100
1.10.2016 Purchased 50 units at ₹ 98 cum-interest.
1.11.2016 Sold 200 units ex-interest at ₹ 99.

Interest dates are March 31 and September 30. Mr. Investor closes his books every December 31. Show the Investment Account as it would appear in his books.

Solution

In the books of Mr. Investor
6% Government Bonds Account
[Interest Payable : 31st March & 30th September]

Dr. **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.1.16	To Bank A/c (Note 1)	60,000	900	59,000	31.3.16	By Bank A/c (Note 3)	—	2,100	—
1.3.16	To Bank A/c (Note 2)	10,000	250	9,800	1.7.16	By Bank A/c (Note 4)	20,000	300	20,000
1.7.16	To Statement of Profit & Loss (Note 4)	—	—	343	30.9.16	By Bank A/c (Note 5)	—	1,500	—
					1.11.16	By Bank A/c (Note 7)	20,000	100	19,800
1.10.16	To Bank A/c (Note 6)	5,000	—	4,900	31.12.16	By Balance c/d (Note 8)	35,000	525	34,393
1.11.16	To Statement of Profit & Loss (Note 7)	—	—	150					
31.12.16	To Statement of Profit & Loss	—	3,375	—					
		75,000	4,525	74,193			75,000	4,525	74,193

Working Notes :

(1) Opening balance of ₹ 900 in interest column represents accrued interest for 3 months (Oct, Nov & Dec). Accrued interest = ₹ 60,000 x 6/100 x 3/12 = ₹ 900.

(2) On 1st March 2016, 100 units were purchased ex-interest @ ₹ 98 each. The actual amount paid = ₹ 9,800 (₹ 98 × 100) for principal and ₹ 250 for accrued interest upto the date of purchase from the date of last payment of interest. Accrued interest = ₹ 10,000 × 6/100 × 5/12 = ₹ 250.

(3) On 31st March, 2016, interest will be received on entire bonds holding on that date including new purchase for 6 months. The amount of interest = ₹ 70,000 × 6 / 100 × 6/12 = ₹ 2,100.

(4) On 1st July 2016, 200 units were sold @ ₹ 100 ex-interest. Total amount received = 200 × ₹ 100 + accrued interest for 3 months (₹ 20,000 × 6/100 × 3/12) = ₹ 20,000 + ₹ 300 = ₹ 20,300.

Profit on Sale of 200 units on 1.7.2016

		₹
Sale proceeds		20,000
Less: Average Cost : $\frac{59{,}000 + 9{,}800}{600 + 100} \times 200$ = ₹ 98.28 × 200		19,657
	Profit on Sale	343

Closing value = ₹ 98.28 × 500 = ₹ 49,140.

(5) On 30th September 2016, interest will be received on entire bonds holding on that date, i.e., (₹ 60,000 + ₹ 10,000 – ₹ 20,000) = ₹ 50,000. Interest = ₹ 50,000 × 6/100 × 6/12 = ₹ 1,500.

(6) On 1st October 2016, 50 units were purchased @ ₹ 98 cum-interest. Cost of investment = 50 × ₹ 98 = ₹ 4,900. Accrued interest is nil because interest has already been paid on 30th September in 2016.

(7) On 1st November 2016, 200 units were sold @ ₹ 99 ex-interest. It means that the accrued interest of ₹ 100 (₹ 20,000 × 6/100 × 1/12) were also received in addition to ₹ 19,800 (₹ 99 × 200).

Profit on Sale of 200 units on 1.11.2016

		₹
Sale proceeds		19,800
Less: Average Cost : $\frac{49{,}140 + 4{,}900}{500 + 50} \times 200$ = ₹ 98.25 × 200		19,650
	Profit on Sale	150

(8) On 31st December 2016, interest will be for 3 months (Oct, Nov & Dec) on ₹ 35,000.
Interest = ₹ 35,000 × 6/100 × 3/12 = ₹ 525.
Balance of Investment on 31.12.2016
₹ 98.25 × 350 = ₹ 34.393 (Actual cost is coming to ₹ 34,390 but ₹ 3 has been adjusted for approximation.)

Illustration 15

Calcutta Investments holds 400, 12% debentures of ₹ 100 each in Acme Ltd., as on April 1, 2016 at a cost of ₹ 50,000. Interest is payable on June 30 and December 31 each year.

On June 1, 2016, 200 debentures are purchased cum-interest at ₹ 21,400.
On November 1, 2016, 300 debentures are sold ex-interest at ₹ 28,650.
On November 30, 2016, 200 debentures are purchased ex- interest at ₹ 19,200.
On December 31, 2016, 300 debentures are sold cum-interest for ₹ 32,250.
Prepare the Investment Account on March 31, 2017.

Solution

In the books of Calcutta Investments
12% Debentures in Acme Ltd. Account
Dr. **[Interest Payable : 30th June & 31st December]** **Cr.**

Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value	Interest (₹)	Cost (₹)
1.4.16	To Balance b/d (Note 1)	40,000	1,200	50,000	30.6.16	By Bank A/c (Note 3)	—	3,600	—
1.6.16	To Bank A/c (Note 2)	20,000	1,000	20,400	1.11.16	By Bank A/c (Note 4)	30,000	1,200	28,650
30.11.16	To Bank A/c (Note 5)	20,000	1,000	19,200	"	By P / L A/c (Note 4)	—	—	6,550
31.3..17	To Statement of Profit & Loss	—	5,200	—	31.12.16	By Bank A/c (Note 6)	30,000	1,800	30,450
					"	By P / L A/c (Note 6)	—	—	2,190
					"	By Bank A/c (Note 7)	—	1,200	—
					31.3.17	By Balance c/d (Note 8)	20,000	600	21,760
		80,000	8,400	89,600			80,000	8,400	89,600

Working Notes :

(1) Opening balance of ₹ 1,200 in interest column represents accrued interest for 3 months (Jan + Feb + March). Accrued interest = ₹ 40,000 × 12/100 × 3/12 = ₹ 1,200.

(2) On 1st June 2016, 200 debentures were purchased cum-interest at ₹ 21,400. It means that the accrued interest for 5 months is included in total payment of ₹ 21,400. Accrued interest = ₹ 20,000 × 12/100 × 5/12 = ₹ 1,000. Therefore, cost = ₹ 21,400 – ₹ 1,000 = ₹ 20,400.

(3) On 30th June 2016, interest will be received on entire debentures holding on that date including new purchase for 6 months. The amount of interest = ₹ 60,000 x 12/100 x 6/12 = ₹ 3,600.

(4) On 1st November 2016, 300 debentures were sold ex-interest at ₹ 28,650. It means that the accrued interest of ₹ 1,200 (₹ 30,000 × 12/100 × 4/12) were also received in addition to ₹ 28,650.

Loss on Sale of 300 debentures on 1.11.2016	₹
Sale proceeds	28,650
Less: Average Cost : $\frac{50,000 + 20,400}{400 + 200} \times 300 =$ ₹ 117.33 × 300	35,200
Loss on Sale	6,550

Closing value = ₹ 117.33 × 300 = ₹ 35,200

(5) On 30th November 2016, 200 debentures were purchased ex-interest at ₹ 19,200. It means that the accrued interest of ₹ 1,000 (₹ 20,000 × 12/100 × 5/12) were also paid in addition to ₹ 19,200.

(6) On 31st December 2016, 300 debentures were sold cum-interest at ₹ 32,250. It means that the accrued interest for 6 months is included in this amount. Accrued interest = ₹ 30,000 × 12/100 × 6/12 = ₹ 1,800. Therefore, net proceeds = ₹ 32,250 – ₹ 1,800 = ₹ 30,450.

Loss on Sale of 300 debentures on 31.12.16	₹
Sale proceeds	30,450
Less: Average Cost : $\frac{35,200 + 19,200}{300 + 200} \times 300 =$ ₹ 108.80 × 300	32,640
Loss on Sale	2,190

(7) On 31st December, 2016, interest will be received on entire debentures holding on that date, i.e., ₹ 20,000. Interest for 6 months = ₹ 20,000 × 12/100 × 6/12 = ₹ 1,200.

(9) On 31st March, 2017, accrued interest will be for 3 months on ₹ 20,000. Accrued interest = (₹ 20,000 × 12/100 × 3/12) = ₹ 600. **Balance of investment on 31st March, 2017** : ₹ 112.80 × 200 = ₹ 21,760.

Some Adjustments for Equity Shares Investment Account

Dividend Received

When dividends on equity shares are declared from pre-acquisition profits, it may be difficult to make an allocation between pre- and post-acquisition profits excepting on an arbitrary basis (e.g., time basis). In such a case, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

Illustration 16

On April 1, 2016, Mr. Subramanium had 20,000 Equity Shares in X Ltd. Face value of the shares was ₹ 10 each but their book value was ₹ 16 per share. On June 1, 2016, Mr. Subramanium purchased 5,000 Equity Shares more in X Ltd. @ ₹ 14 each. On September 1, 2016, X Ltd. declared 15% dividend for the year 2015-16. Mr. Subramanium received the same on September 20, 2016. Show Investment Account upto September 20, 2016.

Solution

In the books of Mr. Subramanium

Dr. Investment in Equity Shares of X Ltd. Account Cr.

Date	Particulars	Nominal Value	Dividend (₹)	Cost (₹)	Date	Particulars	Nominal Value	Dividend (₹)	Cost (₹)
1.4.16	To Balance b/d	2,00,000	—	3,20,000	20.9.16	By Bank A/c (Note 1)		30,000	7,500
1.6.16	To Bank A/c	50,000	—	70,000					

Tutorial Note : 1. Mr. Subramanium was holding 20,000 Equity Shares of X Ltd. on 1st April, 2016. Any dividend in respect of these shares will be treated as dividend from post-acquisition profit. He acquired 5,000 Equity Shares of X Ltd. on 1st June, 2016. The dividend in respect of these shares will be treated as dividend from pre-acquisition profit. Therefore, ₹ 30,000 (₹ 2,00,000 × 15/100) dividend will be credited to Income Account and ₹ 7,500 (₹ 50,000 × 15/100) dividend will be credited to Investment Account (cost column).

Bonus Shares

Bonus shares are issued by capitalising free reserves. A business receives bonus shares on the basis of existing holding, at no cost. Therefore, only the nominal value column of the Investment Account needs amendment. The total nominal value of shares received as bonus will appear in nominal value column only and nothing is recorded in the cost column. In effect, the average cost of the existing shares are reduced.

Illustration 16

On April 1, 2016, Mr. Subramanium had 20,000 Equity Shares in X Ltd. Face value of the shares was ₹ 10 each but their book value was ₹ 16 per share.

On June 1, 2016, Mr. Subramanium purchased 5,000 Equity Shares in X Ltd more @ ₹ 14 each.

On June 30, 2016, the directors of X Ltd. announced a bonus issue. Bonus was declared at the rate of one Equity Share for every five shares held and these shares were received on August 2, 2016.

Show Investment Account upto August 2, 2016.

Solution

In the books of Mr. Subramanium

Dr. Investment in Equity Shares of X Ltd. Account Cr.

Date	Particulars	Nominal Value	Dividend (₹)	Cost (₹)	Date	Particulars	Nominal Value	Dividend (₹)	Cost (₹)
1.4.16	To Balance b/d	2,00,000	—	3,20,000					
1.6.16	To Bank A/c	50,000	—	70,000					
2.8.16	To Bonus Shares A/c	50,000	—	—					

Tutorial Note : Mr. Subramanium will receive 25,000 × 1/5 = 5,000 shares of ₹ 10 each as Bonus Shares at no cost.

Illustration 18

On 1.4.2016, X Limited had 10,000 equity shares of ABC Limited (face value being ₹ 10 each), purchased at par. The company paid brokerage at 1%. On 1.6.2016, the company purchased another lot of 5,000 shares at ₹ 12 each, brokerage being 1%. On 15.8.2016, ABC Limited issued bonus shares at two shares for every three held. On 1.1.2017, X Limited sold 10,000 shares at ₹ 11 per share, brokerage being 1%.

Show Investment Account up to 1.1.2017.

Solution

In the books of X Ltd.

Dr. Investment in Equity Shares of ABC Ltd. Account Cr.

Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)	Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)
1.4.16	To Balance b/d	10,000	—	1,01,000	1.1.17	By Bank b/c (Note 2)	10,000	—	1,12,000
1.6.16	To Bank A/c	5,000	—	60,600	"	By Balance c/d (N 3)	15,000	—	96,960

15.12.16	To Bonus Share A/c (Note 1)	10,000	—	—					
1.1.17	To Statement of Profit & Loss	—	—	44,260					
		25,000	—	2,05,860			25,000	—	2,05,860

Working Notes :

(1) Number of bonus shares received = $\frac{10,000 + 5,000}{3} \times 2 = 10,000$ shares.

(2) Average cost of 25,000 shares = $\frac{1,01,000 + 60,600}{25,000}$ = ₹ 6.464 (approx.).

	₹
Sale proceeds of 10,000 shares	1,10,000
Less: Brokerage 1%	1,100
Net Proceeds	1,12,900
Less: Average cost of 10,000 shares @ ₹ 6.464	64,640
Profit on Sale	44,260

(4) Value of closing balance : 15,000 × ₹ 6.464 = ₹ 96,960.

Rights Shares

When rights shares offered are subscribed for, the cost of the rights shares is added to the carrying amount of the original holding. ***For example***, X Ltd. purchased 10,000 shares of ₹ 10 each at ₹ 25 per share of Y Ltd. during 2014-15. During 2015-16, Y Ltd offered rights issue at one share for every two held at a price of ₹ 20 per share. If X Limited subscribes to the rights issue, the carrying cost of the investment will be as under :

	₹
Cost of original holding (10,000 × ₹ 25)	2,50,000
Cost of rights issue (5,000 × ₹ 20)	1,00,000
Carrying cost of Investments	3,50,000

If rights are not subscribed but are ***sold in the market, the sale proceeds are credited to the Statement of Profit and Loss***. However, where the investments are acquired on cum-rights basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

For example, X Limited purchased 1,000 shares (cum-rights) of ₹ 10 each at ₹ 15 per share of Y Limited and paid ₹ 500 as brokerage. Y Limited offered rights issue at one share for ₹ 12 for every two held. X Limited sold the rights in the market and realised ₹ 1,000. After the rights issue was subscribed, the market value of share fell down from ₹ 15 to ₹ 14.50 per share. In such a case, the decline in the market value [₹ 500 [1,000 × (₹ 15 – ₹ 14.50)] should be adjusted against cost of investment and the balance of ₹ 500 is to be treated as income and is to be credited to Profit and Loss Account / Statement of Profit and Loss.

Illustration 19

On 1.4.2016, X Limited had 10,000 equity shares of ABC Limited, purchased at ₹ 12 each (face value being ₹ 10 per share). On 1.1.2017, ABC Limited offered two rights shares for every five shares held at a premium of ₹ 3 per share. X Limited, however, sold these rights entitlement in the market at ₹ 2 per share. On 1.2.2017 immediately after the shares became ex-right, the market price of the shares fell to ₹ 11.50 each. Show Investment Account up to 1.2.2017.

Solution

In the books of X Ltd.

Dr. Investment in Equity Shares of ABC Ltd. Account Cr.

Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)	Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)
1.4.16	To Balance b/d	10,000	—	1,20,000	1.2.17	By Bank A/c (Note 1)	—	—	5,000
					"	By Balance c/d	10,000	—	1,15,000
		10,000	—	1,20,000			10,000	—	1,20,000

Working Note :

	₹
(1) Sale of rights : 10,000 / 5 × 2 × ₹ 2	8,000
Less: Adjustment for fall in price (10,000 × 0.50)	5,000
Amount transferred to Statement of Profit and Loss	3,000

Tutorial Note : If in the above Illustration, the entire rights entitlement were sold for ₹ 3,000 (instead of ₹ 8,000), the balance of the investments would be shown at ₹ 1,17,000 (₹ 1,20,000 – ₹ 3,000), the income from sale of rights being adjusted against cost.

Illustration 20

On 1.4.2016, Sundar had 25,000 equity shares of X Ltd at a book value of ₹ 15 per share (face value ₹ 10). On 20.6.2016, he purchased another 5,000 shares of the company at ₹ 16 per share. The Directors of X Ltd announced a bonus and rights issue. No dividend was payable on these issues. The terms of the issue are as follows :

Bonus basis 1 : 6 (Date 16.8.2016); Rights basis 3 : 7 (Date 31.8.2016) Price ₹ 15 per share.

Due Date for payment 30.9.2016

Shareholders can transfer their rights in full or in part. Accordingly, Sundar sold $33^1/_3$% of his entitlement to Sekhar for a consideration of ₹ 2 per share.

Dividends: Dividends for the year ended 31.3.2016 at the rate of 20% were declared by X Ltd and received by Sundar on 31.10.2016. Dividends for shares acquired by him on 20.6.2016 are to be adjusted against the cost of purchase.

On 15.11.2016, Sundar sold 25,000 equity shares at a premium of ₹ 5 per share.

You are required to prepare in the books of Sundar : (i) Investment Account; and (ii) Profit and Loss Account.

For your exercise, assume that the books are closed on 31.12.2016 and shares are valued at average cost.

Solution

In the books of Sundar

Dr. Investment in Equity Shares of X Ltd. Account Cr.

Date	Particulars	No.	Dividend (₹)	Cost (₹)	Date	Particulars	No.	Dividend (₹)	Cost (₹)
1.4.2016	To Balance b/d	25,000	—	3,75,000	31.10.2016	By Bank A/c (Note 5)	—	50,000	10,000
20.6.2016	To Bank A/c	5,000	—	80,000	15.11.2016	By Bank A/c (Sale of Shares)	25,000	—	3,75,000
16.8.2016	To Bonus Issue A/c	5,000	—	—					
30.9.2016	To Bank A/c (Rights)	10,000	—	1,50,000	31.12.2016	By Balance c/d (Note 6)	20,000	—	2,64,444
15.11.2016	To Statement of Profit & Loss (Note 7)	—	—	44,444					
31.12.2016	To Statement of P/ L	—	50,000	—					
		45,000	50,000	6,49,444			45,000	50,000	6,49,444

Dr. Profit and Loss Account for the year ended 31st December, 2016 (Includes) Cr.

Particulars	₹	Particulars	₹
		By Income from Sale of Rights	10,000
		By Dividends	50,000
		By Profit on Sale of Shares	44,444

Working Notes :

(1) Bonus Shares = $\frac{25{,}000 \text{ Shares} + 5{,}000 \text{ Shares}}{6} = 5{,}000$ Shares

(2) Rights Shares = $\frac{25{,}000 \text{ Shares} + 5{,}000 \text{ Shares} + 5{,}000 \text{ Shares}}{7} \times 3 = 15{,}000$ Shares

(3) Rights shares subscribed = 2/3 × 15,000 = 10,000 Shares.

(4) Sale of rights entitlement = 1/3 × 15,000 × ₹ 2 = ₹ 10,000.
Amount received by selling rights entitlement will be credited to Profit and Loss Account / Statement of Profit and Loss [AS — 13, Para 13].

(5) Dividend received on shares held on 1.4.2016 = 25,000 × 10 × 20% = ₹ 50,000.
Dividend received on shares purchased on 20.6.2016 = 5,000 × 10 × 20% = ₹ 10,000 will be adjusted to Investment Account.

(6) At the time of calculating cost of shares, ₹ 10,000 (sale of rights) will not be taken into consideration. It will be treated as windfall gain and it will be credited to Profit and Loss Account. However, dividend received on shares purchased on 20.6.2016 — ₹ 10,000 will be taken into consideration.

Cost of 20,000 shares (average basis)

$$= \frac{(3{,}75{,}000 + 80{,}000 + 1{,}50{,}000 - 10{,}000)}{45{,}000} \times 20{,}000 = ₹\ 2{,}64{,}444$$

(7) Profit on Sale of 25,000 Shares on 15.11.2016 ₹

Sale Proceeds 3,75,000

Less : Average Cost $\frac{3,75,000 + 80,000 + 1,50,000 - 10,000}{45,000} \times 25,000$ 3,30,556

Profit on Sale 44,444

Illustration 21

On 1.6.2016 X acquired 3,000 equity shares of ₹ 10 each in ABC Ltd for ₹ 60,000 on *cum-right* basis :

ABC Ltd declared :

(a) a one for three bonus issue on 1.7.2016; and

(b) a one for four rights issue on 1.9.2016 at 20% premium.

X :

(a) took up half the rights issue;

(b) sold the remaining rights for ₹ 8 per share;

(c) sold half of its total shareholdings on 31.12.2016 for ₹ 37,000.

You are required to prepare the Investment Account for the year ended 31.12.2016.

Solution

In the books of X

Dr. Investment in Equity Shares of ABC Ltd. Account Cr.

Date	Particulars	No.	Dividend (₹)	Cost (₹)	Date	Particulars	No.	Dividend (₹)	Cost (₹)
1.6.2016	To Bank A/c (Purchase)	3,000	—	60,000	1.9.2016	By Bank A/c (Note 4)	—	—	4,000
1.7.2016	To Bonus Issue	1,000	—	—	31.12.2016	By Bank A/c (Note 5)	2,250	—	37,000
1.9.2016	To Bank A/c (Rights)	500	—	6,000	31.12.2016	By Balance c/d (N 5)	2,250	—	31,000
31.12.2016	To Statement of Profit & Loss	—	—	6,000					
		4,500		72,000			4,500		72,000

Working Notes :

(1) Bonus Shares = $\frac{3,000 \text{ Shares}}{3} = 1,000$ Shares

(2) Rights Shares = $\frac{3,000 \text{ Shares} + 1,000 \text{ Shares}}{4} = 1,000$ Shares

(3) Rights shares subscribed = 1/2 of 1,000 = 500 shares.

(4) Sale of rights entitlement = 500 × ₹ 8 = ₹ 4,000.
Shares were purchased cum-right, therefore, amount received by selling rights will be credited to Invesment Account [AS — 13, Para — 13].

(5) Cost of shares on 31.12.2016 will be calculated as follows :

$$\frac{\text{Rs } (60,000 + 6,000 - 4,000)}{4,500} \times 2,250 = \text{Rs } 31,000$$

Profit on Sale of 2,250 Shares on 31.12.2016 ₹

Sale Proceeds 37,000

Less : Average Cost : $\frac{60,000 + 6,000 - 4,000}{4,500} \times 2,250$ 31,000

Profit on Sale 6,000

Tutorial Note : At the time of calculating cost of shares on 31.12.2016, amount received by selling rights will be deducted from the total cost of the shares as the shares were purchased **cum-right**.

Illustration 22

The following transactions of Investor Ltd. took place during the year ended 31st March 2017 :

2016

1st April — Purchased ₹ 12,00,000, 8% bonds at ₹ 80.50 cum-interest. Interest is payable on 1st November and 1st May.

12th April — Purchased 1,00,000 equity shares of ₹ 10 each in X Ltd. for ₹ 40,00,000.

1st May	Received half-year's interest on 8% bonds.
15th May	X Ltd made a bonus issue of three equity shares for every two held. Investor Ltd sold 1,25,000 shares for ₹ 20 each.
1st July	Purchased 50,000 equity shares of ₹ 10 each in C Ltd at ₹ 7.75 each.
1st October	Sold ₹ 3,00,000, 8% bonds at ₹ 81 ex-interest.
1st November	Received half-year's bond interest.
1st December	Received 18% dividend on equity shares in X Ltd.
2017	
1st January	C Ltd made a rights issue of one equity share for every two held at ₹ 5 per share. Rights sold in the market at ₹ 2.25 per share.
1st March	Received 12.5% dividend on equity shares in C Ltd.

Prepare the relevant investment account in the books of Investor Ltd for the year ended 31st March, 2017.

Solution

In the books of Investor Ltd.
8% Bonds Account
Dr. [Interest Payable : 1st November & 1st May] [₹ in '000] Cr.

Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)
1.4.2016	To Bank A/c (Note 1)	1,200	40	926	1.5.2016	By Bank A/c	—	48	—
1.10.2016	To Statement of Profit & Loss (Note 2)	—	—	11,5	1.10.2016	By Bank A/c (Note 2)	300	10	243
					1.11.2016	By Bank A/c (Note 3)	—	36	—
31.3.2017	To Statement of Profit & Loss	—	84	—	31.3.2017	By Balance c/d (Note 4)	900	30	694,5
		1,200	124	937,5			1,200	124	937,5

Dr. Investment in Equity Shares of X Ltd. Account Cr.

Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)	Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)
12.4.2016	To Bank A/c	1,00,000	—	40,00,000	15.5.2016	By Bank A/c	1,25,000	—	25,00,000
15.5.2016	To Bonus Issue A/c	1,50,000	—	—	1.12.2016	By Bank A/c	—	2,25,000	—
15.5.2016	To Statement of Profit & Loss (Note 5)	—	—	5,00,000	31.3.2017	By Balance c/d	1,25,000	—	20,00,000
31.3.2017	To Statement of Profit & Loss	—	2,25,000	—					
		2,5,000	2,25,000	45,00,000			2,50,000	2,25,000	45,00,000

Dr. Investment in Equity Shares of C Ltd. Account Cr.

Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)	Date	Particulars	No. of Shares	Dividend (₹)	Cost (₹)
1.7.2016	To Bank A/c	50,000	—	3,87,500	1.3.2017	By Bank A/c (Dividend)	—	62,500	—
31.3.2017	To Statement of Profit & Loss	—	62,500	—	31.3.2017	By Balance c/d	50,000	—	3,87,500
		50,000	62,500	3,87,500			50,000	62,500	3,87,500

Tutorial Note : Amount received ₹ 56,250 (50,000 / 2 × 1 × ₹ 2.25) by selling rights entitlement will be credited to Profit and Loss Account / Statement of Profit and Loss [AS — 13, Para — 13].

Working Notes :

(1) On 1st April, 2016, 12,000, 8% bonds were purchased @ ₹ 80.50 cum-interest. Total amount paid 12,000 × ₹ 80.50 = ₹ 9,66,000 which includes accrued interest for 5 months, i.e., 1st November, 2014 to 1st April, 2016. Accrued interest will be : ₹ 12,00,000 × 8/100 × 5/12 = ₹ **40,000**. Therefore, cost = ₹ 9,66,000 – ₹ 40,000 = ₹ **9,26,000**.

(2) On 1st October, 2016, 3,000 bonds were sold @ ₹ 81 ex-interest. Total amount received = 3,000 × 81 + acccrued interest for 5 months = ₹ 2,43,000 + (3,00,000 × 8 / 100 × 5 / 12 = ₹ 10,000).

Profit on Sale of Bonds on 1.10.2016	₹
Sale Proceeds	2,43,000
Less : Average Cost : $\frac{9,26,000}{12,00,000} \times$ ₹ 3,00,000	2,31,500
Profit on Sale	11,500

(3) On 1st November, 2016, interest will be received for 9,000 bonds @ 8% for 6 months, i.e., ₹ 9,00,000 × 8 / 100 × 1 / 2 = ₹ **36,000**.

(4) Cost of bonds on 31.3.2017 will be : ₹ 9,26,000 / 12,000 × 9,000 = ₹ **6,94,500**.

(5) **Profit on Sale of Shares :**
Cost per share after bonus = ₹ 40,00,000 / 2,50,000 = ₹ 16.
Profit per share sold (₹ 20 – ₹ 16) = ₹ 4.
Therefore, total profit on sale of 1,25,000 shares = ₹ 4 × 1,25,000 = ₹ **5,00,000**.

KEY POINTS

- A **current investment** is an investment that is by its nature readily realisable and is intended to be held for ***not*** more than one year from the date on which such investment is made. The carrying amount for current investments is the lower of cost or fair value.
- A **non-current investment** is an investment other than a current investment. Non-current investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognise the decline. The resultant reduction in the carrying amount is charged to the Profit and Loss Account / Statement of Profit and Loss by creating a provision for diminution. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exists.
- **Purposes of Investment Ledger :** Investment ledger is a special type of ledger which is used by the investing company to record all the details of each investment. The main objectives of maintaining on investment ledger are as follows: (i) it facilitates proper recording of each security separately; (ii) it facilitates collection of interest and dividend as and when they are due; (iii) it helps to determine the value of securities at the end of the accounting period; and (iv) it helps to determine the profit or loss on sale of any security.
- **Meaning of Cum-interest and Ex-interest** : 'Cum' and 'Ex' are Latin words. 'Cum' means with and 'Ex' means without. The terms 'Cum-interest' and 'Ex-interest' relate to fixed interest bearing securities and come up for consideration when those securities are purchased or sold. 'Cum-interest' can be expanded as cumulative or inclusive of interest and 'Ex- interest' can be expanded as exclusive of interest.
- In connection with Cum-interest and Ex-interest, the following points are important : (i) In respect of Government securities and debentures, the price quoted is ex-interest unless otherwise stated; and (ii) In respect of Non-Government securities and debentures, it is cum-interest unless otherwise stated.

THEORETICAL QUESTIONS

1. Distinguish between fixed income bearing securities and variable income bearing securities.
2. Explain the different purposes of maintaining investment ledger.
3. (a) What is cum-interest or dividend ?
   (b) How is it adjusted in the books of account ?
4. (a) In what ways is ex-interest or dividend different from cum-interest or dividend ?
   (b) How is ex-interest or dividend treated in the books of account ?
5. How is dividend from pre-acquisition profit treated in the Investment Account ?
6. How is bonus shares treated in the Investment Account ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Where investments are reclassified from current to long-term, transfers are made at
   A cost
   B the lower of cost and fair value
   C none of these
2. A provision for diminution in the value of a long-term investment should be made when the decline is believed to be
   A temporary
   B permanent
   C none of these

3. A long-term investment is an investment other than
   A investment properties
   B a current investment
   C none of these
4. Investments other than current investments are classified as long-term investments, even though they
   A may be readily marketable
   B may not be readily marketable
   C none of these
5. Any reduction in the carrying amount and any reversals of such reductions should be
   A charged to the profit and loss account
   B credited to the profit and loss account
   C none of these

PRACTICAL QUESTIONS

1. Mr. X furnishes the following details relating to his holding in 6% Government Bonds :
   Opening Balance face value ₹ 60,000 – Cost ₹ 59,000.
   1.3.2016 — 100 units purchased ex-interest at ₹ 98.
   1.7.2016 — Sold 200 ex-interest out of the original holding at ₹ 100.
   1.10.2016 — Purchased 50 units at ₹ 98 cum-interest.
   1.11.2016 — Sold 200 units ex-interest at ₹ 99 out of the original holding.
   Interest dates are 30th September and 31st March, Mr. X closes his books every 31st December. Show the Investment Account as it would appear in his books.
2. On 1.1.2016 Debentures in X Ltd. were held as investment by Y Ltd. to the tune of ₹ 15,000 at the cost of ₹ 16,000. Interest is payable half yearly on 30th June and 31st December. On 1.5.2016 ₹ 6,000 Debentures were purchased at ₹ 5,200 ex-interest and ₹ 3,000 at ₹ 3,060 ex-interest on 1.10.2016. On 1.12.2016 ₹ 2,000 Debentures were sold for ₹ 2,030 ex-interst.
   Show the Investment Account in the books of Y Ltd. Accounts are closed on 31st December every year.
3. Mr. A held on 1st January, 2016 ₹ 1,00,000 of $3^1/_2$% Government loan at ₹ 95,000. Three months interest had accrued. On 31st May he purchased a further ₹ 40,000 of the loan @ ₹ 96 (Net) cum-interest. On 31st July, ₹ 30,000 of the loan was sold at ₹ 94 (Net) ex-interest. On 30th November, ₹ 20,000 of the loan was sold at ₹ 96 (Net) cum-interest. Interest on the loan was paid each year on 31st March and 30th September and was collected on 4th April and 5th October. The price of the loan on 31st December 2016 was ₹ 96. Draw-up the Loan Account. Ignore income-tax and paise.
4. On 1.1.2016, 6%, 200 Debentures of ₹ 100 each in Y Ltd., were held as investments by X Ltd. at a cost of ₹ 18,200. Interest is payable on 31st December. On 1.4.2016, ₹ 4,000 of such debentures were purchased by X Ltd. @ ₹ 98 and on 1.9.2016 ₹ 6,000. Debentures were sold at ₹ 96 ex-interest. On 1.12.2016 ₹ 8,000 Debentures were sold @ ₹ 99 cum-interest. On 31.12.2016, X Ltd. sold ₹ 10,000 Debentures @ ₹ 95. Prepare Investment Account for 6% Debentures of Y Ltd. in the books of X Ltd. Ignore income-tax.
5. Nicco-Uco Finance Co. Ltd. had on 1st January 2016, 6% Government of West Bengal Bonds of the face value of ₹ 80,000 valued at ₹ 79,600 on which interest accrued for three months on that date. On 30th April, 2016 the company purchased more bonds of the face value of ₹ 60,000 at par (cum- interest) including brokerage and other expenses. It sold on 31st August, 2016, ₹ 40,000 of the bonds @ ₹ 99.75 (ex-interest), and on 30th November, 2016, ₹ 30,000 of them @ ₹ 100.60 (cum-interest), after deduction of brokerage and other expenses in both the cases. Interest falls due on 31st March and 30th September every year and is credited after collection by the bank after two days. On 31st December, 2016 the bonds were quoted at ₹ 99.65. Give the Investment Account of the bond in the books of the investment company.
6. On 1st April, 2016, XY & Co. Ltd. held 9% Debentures in B Ltd. of the face value of ₹ 10,000 at a cost of ₹ 8,000. Market value on that date was ₹ 9,000. Interest is payable on 31st December every year on 1st December, 2016. Debentures of nominal value of ₹ 6,000 were purchased for ₹ 5,000 ex-interest and on 31st December, 2016. Debentures of nominal value of ₹ 2,000 were sold cum-interest for ₹ 1,900.
   On 1st January, 2017 Debentures of nominal value of ₹ 6,000 were brought at ₹ 5,800. The market value of the Debentures on 31st March, 2017 was at ₹ 90. Make out 9% Debentures Account in the books of XY & Co. Ltd., showing profit and loss on sale of investment. Stocks on 31st March each year are valued at lower of cost or fair value.

7. Bonanza Limited held on 1st April, 2016 ₹ 2,00,000 of 9% Government Loan (2018) at ₹ 1,90,000 (face value of Loan ₹ 100 each). Three month's interest had accrued on the above date.
On 31st May, 2016 the company purchased the same Government Loan of the face value of ₹ 80,000 at ₹ 95 (net) cum-interest. On 1st June, 2016, ₹ 60,000 face value of the loan was sold at ₹ 94 (net) ex-interest. Interest on the loan was paid each year on 30th June and 31st December and was credited by the bank on the same date. On 30th November, 2016, ₹ 40,000 face value of the Loan was sold at ₹ 97 (net) cum-interest. On 1st December, 2016, the company purchased the same loan ₹ 10,000 at per ex-interest. On 1st March, 2017 the company sold ₹ 10,000 face value of the loan at ₹ 95 ex-interest. The market price of the loan on 31st March, 2017 was ₹ 96. Draw up the 9% Government Loan (2018) Account in the books of Bonanza Limited. The loan held by the company shall be valued at total average cost or market price, whichever is lower. Calculation shall be made to the nearest rupee or multiple thereof.
8. Mr. Shape dealt on the stock exchange and had purchased and sold leading scripts but did not maintain his accounts in a proper manner. He furnished the following data :
Investments on hand as on July 1, 2016 :
300 — 3% Conversion loan 2016-2017 of ₹ 100 each purchased at ₹ 60.
250 — Equity shares of ₹ 10 each of Everlite Ltd. at ₹ 18 per share.
100 — 9% preference shares of ₹ 100 each on Prosperous Ltd. at ₹ 95 per share.
Transactions during the year :
Purchases : 750 equity shares of ₹ 10 each of Everlite Ltd. at ₹ 23.
250 equity shares of ₹ 10 each of Small Ltd. at ₹ 9.
125 equity shares of ₹ 10 each of bright shipping Ltd. at ₹ 12.
Sold : 100 — 3% Conversion loan 2016-2017 at ₹ 65.
100 — 9% Preference shares of Prosperous Ltd. at ₹ 99.
Interest / Dividends received :
3% conversion loan — interest received — ₹ 900.
9% preference shares of Prosperous Ltd. — ₹ 9,000.
Everlite Ltd. — Dividend at 20% on 1,000 shares — ₹ 2,000.
Everlite Ltd. issued bonus shares and Mr. Shape received 1,000 equity shares of the company as bonus shares.
You are required to show the Investment Account in Mr. Shape's books
9. On 1.1.2016, X Ltd. had 10,000 equity shares of ₹ 10 each in Alpha Ltd. purchased for ₹ 1,25,000. The company unlike investment companies does not make any apportionments of dividends (received or receivable) in between capital and revenue. On 15.5.2016, Alpha Ltd. made a bonus issue of 1 fully paid share for 2 held on 15.5.2016. In addition, on the same day rights shares were issued at 3 for 5 held on that date at a premium of ₹ 3, ₹ 7 to be paid on application and the balance in one call after a month. These shares are not to rank for dividend for the year ending 30th June, 2016. 2,000 rights shares were taken up by X Ltd. Balance rights being sold at ₹ 2 each on 25.5.2016. On 15.10.2016, the company declared a dividend of 20% for the year ending 30th June, 2016.
Make out the Investment Account in the books of X Ltd. Ignore income-tax.
10. In preparing the financial statements of R Ltd for the year ended 31.3.2017, you come across the following information. State with reasons, how would you deal with them in the financial statements :
An unquoted long-term investment is carried in the books at a cost of ₹ 2,00,000. The published accounts of the unlisted company received in May, 2017 showed that the company was incurring cash losses with declining market share and the long-term investment may not fetch more than ₹ 20,000.
11. On April 1, 2016 Singh had 20,000 equity shares in X Ltd. The face value of the shares were ₹ 10 each but their book value was ₹ 16 per share.
On June 1, 2016, Singh purchased 5,000 more equity shares in the company at a premium of ₹ 4 per share.
On June 30, 2016, the directors of X Ltd. issued a bonus and rights issue. Bonus was declared at the rate of one equity shares for every five shares held, and these shares were received on August 2, 2016.
The terms of the rights issue were :
(1) Rights shares to be issued to the existing holders on August 10, 2016.
(2) Rights issue would entitle the holders to subscribe to additional equity shares in the company at the rate of one share per every three shares held at ₹ 15 per share — the whole sum being payable on September 30, 2016.
(3) Existing shareholders may, to the extent of their entitlement, either wholly or in part, transfer their rights to outsiders.
(4) Singh exercised his option of 50% of his entitlements, under the issue and the balance of rights he sold to Ananth for a consideration of ₹ 1.50 per share.
(5) Dividends for the year ended March 31, 2016 at a rate of 15% were declared by the company and received by Singh on October 20, 2016.

(6) On November 1, 2016 Singh sold 20,000 equity shares at a premium of ₹ 3 per share.
Show the Investment Account as it would appear in Singh's books as on December 31, 2016 and the value of shares held (average basis) on that date assuming the accounting year is April 1 to March 31.

12. Raghav Rathore carried out the following transactions in connection with his investments during the year ended 31 March, 2016 :

2014	
April 15	Purchased ₹ 4,00,000, 12% convertible debentures in Salora Ltd at ₹ 125.50. Interest is payable on 15 September and 15 March. The debentures are convertible into equity shares of ₹ 10 each at the rate of ₹ 20 for each equity share.
June 1	Purchased ₹ 10,00,000, 12% debentures in Sumana Ltd for ₹ 11,00,000. Interest is due for payment on 1 October and 1 April.
June 15	Converted the debentures in Salora Ltd into equity shares. On this date, the market price of the shares was ₹ 20. The accrued interest to date was paid.
August 25	Received 20% dividend on the equity shares in Salora Ltd.
December 15	Salora Ltd made a rights issue of one equity share for every 20 shares held at ₹ 16 per share. The market value of shares was ₹ 20.
2016	
January 10	Rathore sold the right for ₹ 3 per share.
March 15	Sold 4,000 equity shares in Salora Ltd at ₹ 25 per share.

You are required to record the above transactions in the Ledger of Rathore. Maintain separate account for each category of investment. Ignore tax and brokerage charges. Rathore's accounting year ends on 31 March.

Guide to Answers

Multiple Choice

1. B; 2. A; 3. B; 4. A; 5. C.

Practical Questions

1. **Profit on sale of investment — ₹ 467 (Total); Interest transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 3,375; Cost of Investment at the end of the year — ₹ 34,367 (Face value ₹ 35,000).**
2. **Profit on sale of investment — ₹ 10; Interest transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 1,567; Cost of investment at the end of the year — ₹ 22,267 (Face value — ₹ 22,000).**
3. **Profit on sale of investment — ₹ 83; Interest transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 4,347; Cost of investment at the end of the year — ₹ 85,667 (Face value — ₹ 90,000).**
4. **Profit on sale of investment — ₹ 680; Interest transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 1,220; Cost of investment at the end of the year — ₹ 9,500.**
5. **Profit on sale of investment — ₹ 330; Interest transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 6,250.**
6. **Profit on sale of investment — ₹ 120; Interest transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 1,170; Cost of investment at the end of the year — ₹ 17,200 (Face value — ₹ 20,000).**
7. **Nominal value — ₹ 1,12,000; Amount — ₹ 1,68,500; Interest — ₹ 18,525.**
8. **3% Conversion Loan : Profit on sale — ₹ 500; Value of investment at the year end — ₹ 12,000.**
   Equity Shares (Everlite Ltd.) : Value of investment at the year end — ₹ 21,750.
   9% Preference Shares : Profit on sale — ₹ 400, Value of investment at the year end — ₹ 85,500.
9. **Dividend transferred to Profit and Loss Account / Statement of Profit and Loss — ₹ 20,000; cost of investment at the end of the year — ₹ 1,51,000. (Face value ₹ 1,70,000). Sale of rights entitlement = ₹ 8,000 (4,000 × ₹ 2) will be credited to Profit and Loss Account / Statement of Profit and Loss as per AS—13, Para 13.**
10. **A provision for diminution of ₹ 1,80,000 should be made to recognise this permanent decline in value.**
11. **Cost of investment at the end of the year — ₹ 1,96,111; Loss on sale of shares ₹ 1,429. (Sale of rights for ₹ 7,500 will be credited to Profit and Loss Account / Statement of Profit and Loss as the shares were not purchased cum-rights.)**
12. **(a) Cost of debentures purchased on 15th April — ₹ 4,98,000 (₹ 5,02,000 – ₹ 4,000).**
    (b) Sale of rights entitlement ₹ 4,000 will be credited to Profit and Loss Account / Statement of Profit and Loss. Profit on sale of 4,000 shares in Salora Ltd. on 15th March, 2016 — ₹ 400.
    (c) Cost of investment in equity shares of Salora Ltd. at the year end — ₹ 3,98,400.
    (d) Cost of investment in 12% debentures of Sumana Ltd. at the year end — ₹ 10,80,000.

18

Conceptual Framework

Introduction

Financial statements are the most important source of information for the outsiders (e.g., investors and creditors). These statements — the Balance Sheet, Profit and Loss Account and Cash Flow Statement — provides information about the financial position, performance and cash flow of an enterprise which is useful to a wide range of users in making economic decisions.

Accountants encounter many problems while preparing financial statements. For example, the treatment of research and development expenditure, heavy advertisement expenses for launching a new product, etc. Many concepts / conventions have been developed over the years in response to the problems encountered by the accountants. These concepts / conventions have been criticised from time to time because they offer only broad guidelines to the accountants. Many accountants believe that accounting conventions do not provide an adequate basis for the development of accounting.

In order to deal with the increasing complexity of financial transactions we need to develop a framework. This conceptual framework should provide us answers to fundamental questions such as :

(i) how should this be recorded ?
(ii) how should this be measured ?
(iii) how should this be reported ?

In late seventies and early eighties the Financial Accounting Standards Board (FASB) in the USA took steps for the development of a conceptual framework for accounting.

Based on FASB's conceptual framework, many standard-setting and professional bodies, including the Institute of Chartered Accountants of India have developed conceptual framework that establish a broad set of accounting principles on which these standards and accounting rules are based.

Purpose of the Framework

This framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the framework is to :

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;
(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;
(c) assist the Accounting Standard Board in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;
(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;
(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and
(f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

Status of Framework

The framework does not have the status of an accounting standard and does not override any specific accounting standard where conflicts arise.

Where an accounting issue is not dealt with specifically by an accounting standard, the framework is referred to by the accountants.

The framework will be revised from time to time on the basis of the experience of the Accounting Standard Board of Working with it.

Scope

The framework deals with
(a) the objective of financial statements;
(b) the qualitative characteristics that determine the usefulness of information provided in financial statements;
(c) definition, recognition and measurement of the elements from which financial statements are constructed; and
(d) concept of capital and capital maintenance.

The framework is concerned with general purpose financial statements. Special purpose financial reports, for example, different prospectus and computations prepared for taxation purposes are outside the scope of this framework.

A complete set of financial statements normally includes a Balance Sheet, a Statement of Profit and Loss, a Cash Flow Statement and those notes and other statements and explanatory material that are integral part of the financial statements.

The framework applies to the financial statements of all reporting enterprises, whether in the public or in the private sector.

To ensure that the framework helps to provide useful information, it is important to identify the users of financial statements.

The users of financial statements include :

- Investors (present and potential)
- Employees
- Lenders
- Suppliers and other trade creditors
- Customers
- Government and their Agencies
- Public

While all the information needs of these users cannot be met by financial statements, there are needs which are common to all users. The framework does not indicate that the needs of one set of users are more important than any other. Investors need more comprehensive information. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

Objective of Financial Statements

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

Information about ***financial position*** is primarily provided in the ***Balance Sheet***. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency and its capacity to adapt to changes in the environment in which it operates.

Information about ***performance*** is provided in the ***Profit and Loss Account***. Information about performance, in particular its profitability, is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgments about the effectiveness with which the enterprise might employ additional resources.

Information about ***cash flows*** is provided in the ***Cash Flow Statement***. Information about cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period.

The framework states that financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events; and (b) they do not necessarily provide non-financial information.

Notes and Supplementary Schedules

The financial statements also contain notes on accounts and supplementary schedules and other information.

The notes on accounts and supplementary schedules may provide vital information which may influence the investors decision. For example : pending law suit for violation of patents.

Underlying Assumptions

Accrual Basis

Unless otherwise stated, the users of financial statements assume that the financial statements have been prepared on ***accrual basis***. Accrual basis of accounting recognises revenues and expenses as they are earned or incurred respectively, without regard to the date of receipt and payment of cash.

Example 1 : X Ltd. sold goods of Rs 10,00,000 on 20th March, 2008. Credit term — one month. At the time of preparing financial statements for the period 2007-08, this revenue from sale of Rs 10,00,000 will be recognised in the accounts of 2007-08, though cash will be received in the next financial year.

Example 2 : X Ltd has received electricity bill for the month of March 2008. The due date for payment is 10th April, 2008. As the electricity bill is related to accounting year 2007-08, it should be recognised as expenses for the year 2007-08, though the payment to be made in the next financial year.

Going Concern

Unless otherwise stated, the users of financial statements assume that the enterprise is a going concern and it will continue operation for the foreseeable future.

It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations. The financial statements have been prepared on going concern basis. (That is why the assets have been valued at ***historical cost*** not at the net realisable value.)

Consistency

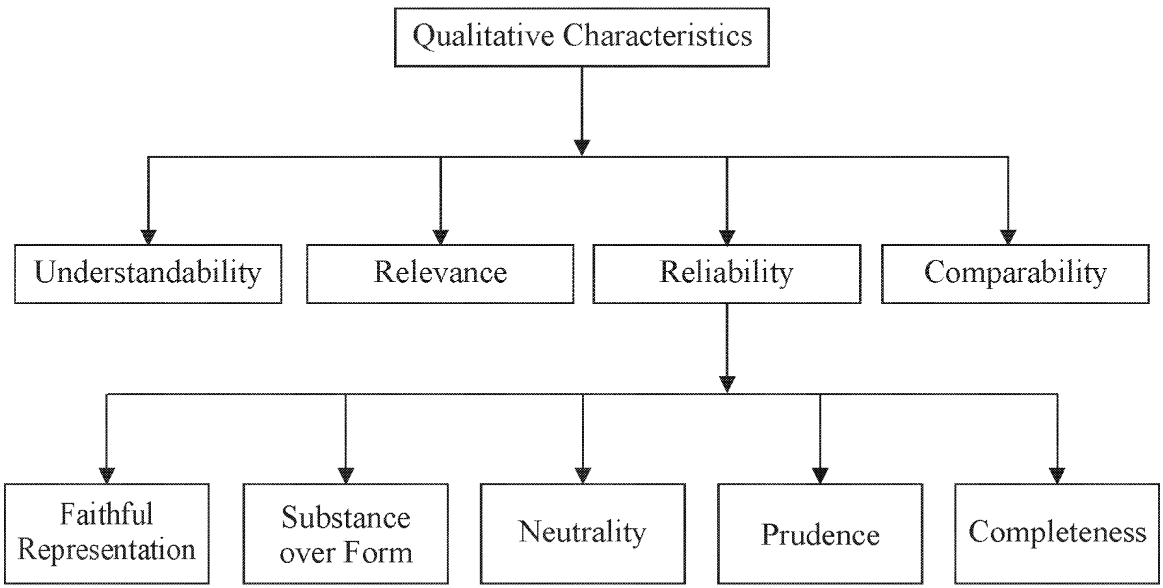
In order to achieve comparability of the financial statements of an enterprise through time, it is assumed that there is no change in the accounting policies from one period to another.

For example, X Ltd. charging depreciation following straight line method for last 5 years (2002-03 to 2006-07). The users of financial statements will assume that the straight line method of depreciation has been adapted at the time of preparation of financial statements for the year 2007-08 also.

Qualitative Characteristics of Financial Statements

Accounting information must possess some qualitative characteristics. These are the attributes that make the information provided in the financial statements useful to users. The ***four*** main qualitative characteristics are:

(1) Understandability;
(2) Relevance;
(3) Reliability; and
(4) Comparability.



Understandability

Understandability is the quality of accounting information that enables users to perceive its significance, i.e., to understand the content and significance of accounting statements and reports. If a user cannot understand the accounting information given to him, it is not useful, even though it may be relevant to whatever decision he wants to make. To have the characteristics of understandability, accounting information must be presented in a manner that users can understand, i.e., it must be expressed in terminology that is understandable to the users. Now-a-days, business activities and transactions have become increasingly complex. It may not always be possible to describe complex transactions in simple terms. It is, therefore, necessary that the users of the accounting information must attain a minimum level of competence in understanding the terminology used in accounting statements. It is assumed that the users have a basic knowledge of business accounting, and they will spend some time and effort in studying the accounting statements. However, the accountant has a basic responsibility to describe business transactions clearly and concisely.

Relevance

Accounting information must be relevant to the user. Information is relevant if it meets the needs of the user in decision-making. Relevance is *defined* in terms of the ability to affect a decision-maker's course of action, because whether a particular set of accounting information is relevant or not depends on the specific decision-maker's objectives. Thus, for information to be relevant, it must have some bearing on the decision being made. Relevant accounting information should be capable of making a *difference* in a decision by helping users of accounting information to form predictions about the outcomes of past, present and future events. The decision *not* to modify or correct previous actions is a very important one. Financial information which does not have relevance to users is worse than no information at all, i.e., any information does not connote utility if it is not relevant to the purpose. To be relevant, it should be capable of monetary computation.

Reliability

Accounting information should be reliable. Reliability is the characteristic of accounting information which gives the user confidence and trust that the reported information is a reasonable representation of the actual items or events that have occurred. To be reliable, the accounting information should be error-free and neutral — an accountant's bias must not colour his information. The other subsidiary qualities which make information reliable are as follows :

Faithful representation : Information must faithfully represent the effects of transactions and other events. If the information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

For example, X Ltd has purchased a building for their sales office. The rights and beneficial interest in the property have been transferred but the documentation and legal formalities are pending. It is to be shown in the financial statement as own property though legally it has not been transferred in the name of X Ltd.

Substance over Form : The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form. In accounting, substance should normally take *precedence* over form in deciding how a particular transaction should be recorded. The legal form of a transaction is frequently descriptive of its economic substance. However, the form occasionally misrepresents the characteristics that are relevant to users. If the substance can be reliably determined, the accountant should describe the transaction in terms of the substance rather than the form. Accounting for hire-purchase transactions, for example, is based on the above concept, i.e., it looks at the substance of the transaction rather than its legal form. The hire-purchaser can record the asset at its cash down price, while paying for it by instalments over an agreed period of time.

Neutrality : Judgement is required in arriving at many items in the financial statements. Judgement is involved in valuing stock, determining the amount of doubtful debts, etc. Neutrality means that these judgements are made without any bias.

Prudence : Caution must be exercised while preparing financial statements and estimating the outcome of uncertain events. For example, collectability of receivable, the warranty claims that may occur etc. However, this does not mean, that the approach should be over cautious. The aim should be to report most likely outcome, with a reasonable element of caution. The financial statements must not be prepared on the most optimistic basis.

Completeness : The information in the financial statements must be complete within the bounds of materiality and cost.

Comparability

Usefulness is enhanced if accounting information can be compared with similar information for the ***same organisation*** at different times, and for ***different organisations*** at the same time. Comparability enhances the value of accounting information by enabling the users to discern and detect similarities and the dissimilarities among different concerns as also in respect of the same concern over time. Absoluteness of the information is not of much use — it is the comparability that lends itself to proper decision-making. Whether one is doing well or not is not the enquiry; the enquiry should be whether one is doing better or more (or worse) than others or than in other periods. To achieve comparability, consistency and disclosure of accounting policies are necessary.

Elements of Financial Statements

The framework provides definitions of the elements of financial statements. The elements directly related to the measurement of financial position in the Balance Sheet are : ***assets***, ***liabilities*** and ***equity***.

The elements directly related to the measurement of performance in the Statement of Profit and Loss are : ***income*** and ***expenses***.

These definitions applied together with the recognition criteria, helps to understand how and when the financial effect of transactions should be recognised in the financial statements.

Definitions

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

This definition stresses on the right to control the asset rather than the legal ownership. Based on this, a plant taken on finance lease can give rise to an asset (without transfer of legal ownership).

(b) A ***liability*** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

The obligation referred to in the definition need not constitute a legal duty. For example, legal obligation to pay income tax may not arise until several months after the closing the accounting period but would, nevertheless, appear as a liability on the Balance Sheet at the end of the accounting period. The key issue is whether or not the transfer of economic benefits can be avoided.

(c) ***Equity*** is the residual interest in the assets of the enterprise after deducting all its liabilities.

Assets – Liabilities = Equity (or Capital).

In case of a limited company, the equity will be represented by the share capital *plus* any reserve.

(d) ***Income*** is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease in liabilities, that in turn increases the equity other than those relating to contribution from equity participants.

(e) ***Expenses*** are decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Assets

Assets are those resources that the business owns. They refer to some property or legal right owned by a business enterprise which can be measured in terms of money.

An asset has the following ***three*** essential characteristics :

(1) It has the potential to provide future economic benefits to the enterprise.
(2) It is a result of past transactions or events.
(3) The enterprise has the control over it.

Liability

Liability is a present obligation expressed in terms of money, which arises from transactions or other events that have already occurred. It involves an enterprise in a probable future transfer of cash, goods or services or the foregoing of a future cash receipt.

Obligations may arise from normal business practice, custom and a desire to maintain good business relations.

For example, if a mobile phone company as a matter of policy replaces faulty battery of mobile phones whether covered by warranty or not, the amount that is expected to be expensed in respect of mobiles already sold are liabilities.

Recognition of the Elements of Financial Statements

An item that meets the definition of an element (given above) should be recognised if :

(a) it is possible that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) the item has a cost or value that can be measured with reliability.

In the ***first criterion***, the concept of probability is used to refer to the degree of uncertainty. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared.

For example, the probability that your credit customers will pay in future and based on that you can include receivables in the Balance Sheet.

The ***second criterion*** for the recognition of an item is that it possesses a cost or value that can be measured with reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the Balance Sheet or Statement of Profit and Loss.

For example, the damages payable in a law suit may meet the definitions of both liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

Recognition of Assets

An asset is recognised in the Balance Sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

If there is any doubt about the flow of benefits to the enterprise beyond current accounting period, the expenditure incurred will not be recognised as an asset.

Recognition of Liabilities

A liability is recognised in the Balance Sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

Recognition of Income

Income is recognised in the Statement of Profit and Loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Recognition of Expenses

Expenses are recognised in the Statement of Profit and Loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

An expense is recognised immediately in the Statement of Profit and Loss when an expenditure produced no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the Balance Sheet as an asset.

Measurement of Elements of Financial Statements

After deciding that an item is to be recognised in the financial statements, the next step is to decide the basis for its measurement.

The framework refers to ***four*** measurement bases that are frequently used in reporting. These are :

1. Historical Cost
2. Current Cost
3. Realisable (Settlement) Value
4. Present Value

In measuring assets and liabilities, the historical cost is most commonly used. This is usually combined with other measurement bases. For example, inventories are usually carried at lower of cost and net realisable value (NRV) and pension liabilities are carried at their present value.

Concept of Capital and Capital Maintenance

Concept of Capital

The framework refers to two concepts of capital :

(a) Financial concept of Capital
(b) Physical concept of Capital

Under financial concept of capital, capital is synonymous with the net assets or equity of the enterprise.

Under physical concept of capital, capital is regarded as the productive capacity of the enterprise.

Determination of Profit

Under the financial concept of capital a profit is earned if financial amount of the net assets at the end of the period is greater than at the beginning of the period after deducting any distributions to and contributions from owners.

Under physical concept of capital, a profit is earned if physical productive capacity of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after deducting any distributions to and contributions from owners.

Capital Maintenance

It is assumed that, an enterprise has maintained its capital if it has more capital at the end of the accounting year than that at the beginning of the year. The main point in capital maintenance is to decide which concept to be adopted.

Financial capital maintenance is measured either in nominal monetary units or units of constant purchasing power.

Physical capital maintenance concept requires the adoption of the current cost basis of measurement — an appreciation of what it would cost to ***replace assets at current prices***.

The main difference between two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprises.

Necessity of Conceptual Framework

1. Conceptual frameworks can act as a ***point of reference*** for standard setters, accountants and users of accounting information.
2. A conceptual framework can provide guidance for treatment of ***similar items*** by referring to definitions and criteria.
3. Conceptual framework helps to remove the need of addressing the underlying issues over and over again.
4. If an item has not been specifically addressed in an accounting standard, a conceptual framework can given guidance for its accounting treatment.
5. A conceptual framework can provide a ***short term solution*** of some technical issues which must be addressed immediately.

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Introduction to Accounting Standard

Introduction

Accounting standards are accounting rules and procedures relating to measurement, valuation and disclosure issued by the Council of The Institute of Chartered Accountants of India. Accounting standards are stated to be the norms of accounting policies and practices by way of guidelines that should be followed while preparing accounts and disclosed in the annual financial statements. The accounting standards are intended to apply only to items which are material.

Since accounting standards are the rules to be followed in the preparation of financial statements, these are regarded as a *mechanism* for resolving the conflicts of interest among various preparers and users of accounting information. Accounting standards are generally appropriate to the normal conduct of business and are in conformity with local conditions. Accounting standards serve public interest and are based on a conceptual framework of accounting. Necessarily, the utility of accounting standards results in a consequential improvement in the quality of preparation of financial statements.

Nature

Accounting standards are *mandatory* in nature. They are mainly applicable to the published accounts of limited companies. However, in case of sole proprietorships or partnerships, accounting standards mandatorily apply when the financial statements are statutorily required to be audited.

The accounting standards apply to the preparation of general purpose financial statements, i.e., Balance Sheet, Profit and Loss Account, and other statements and statutory notes which form part of the financial statements. It is necessary to examine whether the mandatory accounting standards are complied with in the preparation of financial statements. If there is any deviation, adequate disclosure should be made so that the users of financial statements become aware of such deviations.

Accounting policies have a *direct effect* on the working results and the financial position of a business concern. Accounting policies are the specific accounting bases adopted and constantly followed by a business unit in the preparation of its financial statements. Owing to varying circumstances, different accounting policies are adopted by different business enterprises. Accounting standards, therefore, require that all significant policies adopted in the preparation and presentation of financial statements should be disclosed and should form part of the financial statements. Any change in the accounting policies which has a material effect, and the amount by which any item in the financial statement is affected by such a change should be disclosed. Lastly, if a fundamental *accounting assumption* is not followed, the fact should be disclosed.

Accounting standards could be national, international or both. Every national institute frames its own accounting standards, which generally are in keeping with the international norms. In effect, the development of accounting standards in India has been contemporaneous with that of the International Accounting Standards, which are formulated by global organisations of accounting bodies. As such, there is not much difference among the parameters of these standards.

Scope

1. Accounting Standards are to be issued in conformity with the provisions of the applicable laws, customs, usages and business environment of our country. If there is any conflict between the accounting standards and laws (because of subsequent amendments in the law), the provisions of the said law will prevail and financial statements should be prepared in conformity with such law.
2. Accounting Standards can not override the local regulations.
3. Accounting Standards are intended to apply only to items which are material.
4. The Institute will use its best endeavours to persuade the government, appropriate authorities, industrial and business community to adopt these standards in order to achieve uniformity in the preparation of financial statements.
5. In carrying out the task of formulation of Accounting Standards, the intention would be to concentrate on basic matters.

Purposes

The concepts of accounting have permitted a variety of practices to follow and, in effect, different results can be drawn from the same set of data. Consequently, the lack of uniformity of such practices has made it difficult for users of accounting information to compare the results of different firms. The overall direction of the accountant should be towards *uniformity*, so that accounting information may become comparable, leading to better analysis and comparison of performances.

The need for accounting standards is based on the necessity of harmonising the diverse policies and practices adopted by different business firms. When accounting standards are followed, accounting information become transparent and, in effect, it helps towards meaningful comparison and study. It also ensures consistency in the accounting statements of a business enterprise from year to year. In effect, it facilitates a more meaningful comparison among accounting statements of different enterprises. As a result, the users of accounting information can understand and make proper use of accounting statements for decision-making.

The need for the *uses* of accounting standards are as follows :

(1) Accounting standards promote better understanding of accounting statements, the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the statements.
(2) Accounting information is more useful if it is published on a comparable basis, and *comparability* is not possible without accounting standards.
(3) Accounting standards provide a generally accepted language for financial statements that renders them more comprehensible to the users of accounting information.
(4) Accounting standards may be regarded as a means to establish that the collective wisdom and experience rather than the viewpoint of individual accountant may prevail in the matter.

Accounting Standard Board (ASB)

On April 21, 1977, The Institute for Chartered Accountants of India constituted the Accounting Standard Board (ASB) for formulation of Accounting Standards in India. The main functions of ASB is to formulate different accounting standards after taking into consideration the applicable laws, customs, usages and business environment. ASB will issue guidance notes on the Accounting Standards and give clarifications on issues arising therefrom.

ASB will also review the Accounting Standards at periodical intervals. However, the Accounting Standards will be issued under the authority of the Council of the Institute of Chartered Accountants of India.

Procedure for Issuing Accounting Standards

Broadly, the following procedures are adopted by ASB for formulating Accounting Standards :

1. Determination of the broad areas in which Accounting Standards need to be formulated.
2. Formulation of Study Groups. At the time of formation of study groups, provisions will be made for wide participation by the members of the Institute and others. The study groups will help ASB in the preparation of the Accounting Standards.
3. Holding of dialogue by ASB with the representatives of the Government, Public Sector Undertakings, Industry and other organisations for ascertaining their views.
4. Preparation and publication of an exposure draft of the proposed standard for comments by members of the Institute and the public at large. An exposure draft is prepared on the basis of the work of the study groups and the dialogue with the different parties as mentioned above.

The draft of the proposed standard will include the following basic points :
(a) A statement of concepts and fundamental accounting principles relating to the Standard.
(b) Definitions of the terms used in the Standard.
(c) The manner in which the accounting principles have been applied for formulating the Standard.
(d) The presentation and disclosure requirements in complying with the Standard.
(e) Class of enterprises to which the Standard will apply.
(f) Date from which the Standard will be effective.

5. Finalisation of the draft by ASB after considering the comments received from different corners.
6. Submission of the final draft to the Council of the Institute of Chartered Accountants of India.
7. The Council will consider the final draft of the proposed standard and if found necessary modify the same in consultation with ASB.
8. Publication of the Standard on the relevant subject under the authority of the Council.

National and International Accounting Authorities

In response to the long felt need for standardisation of accounting on a global scale, the International Accounting Standards Committee (IASC) was formed in 1973. This leading professional accounting institute of nine developed countries was set up for securing more sophistication and precision in accounting procedure worldwide. In 2001, the IASC was dissolved and the IASB (International Accounting Standard Board) was established.

The sixteen accounting bodies from these nine nations are as follows :

Sl. No.	Nations	Sl. No.	Bodies
1.	Australia	1.	The Institute of Chartered Accountants in Australia.
		2.	Australian Society of Accountants.
2.	Canada	3.	The Canadian Institute of Chartered Accountants.
3.	France	4.	Order des Experts Compatables et des Compatables Agrees.
4.	Germany	5.	Institut der Wirtschaftspirufer in Deutschland e.V.
		6.	Wirtschaftspruferkammer.

5.	Japan.	7.	The Japanese Institute of Certified Public Accountants.
6.	Mexico.	8.	Instituto Mexican de Contadores Publicos
7.	Netherlands	9.	Netherlands Institute van Register - Accountants.
8.	United Kingdom & Ireland	10.	The Institute of Chartered Accountants in England & Wales.
		11.	The Institute of Chartered Accountants of Scotland.
		12.	The Institute of Chartered Accounts in Ireland.
		13.	The Association of Certified Accountants.
		14.	The Institute of Cost and Management Accountants.
		15.	The Chartered Institute of Public Finance and Accountancy.
9.	United States of America	16.	The American Institute of Certified Public Accountants.

The revised agreement and constitution were signed in November 1982. Both the Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India are the members of the IASC.

Adoption of International Financial Reporting Standard (IFRS)

Introduction

In the last decade of the past century phenomenal growth in the fields of communication and transportation has created the concept of an economic global village and this has given tremendous thrust in trade and commerce worldwide.

In the present scenario, the corporate entities are going for cross border businesses. More and more countries are opening their doors to foreign investments. Many foreign companies, e.g., Nokia, Toyota, Honda, HP and Dell computers are investing huge amount of capital in India and China. Similarly, many Indian companies are also investing in foreign countries, for example, Tata Motors Ltd., has invested in UK, Korea and Thailand, etc. In the same way, Reliance Industries Ltd. has invested in Brazil, Iraq, etc.

In addition, more and more Indian companies are increasingly accessing the global capital market to fulfill their capital needs.

For example:

During 2014-15, more than ₹ 1,20,000 crores of capital were arranged from global market by the Indian Companies [Source: Hindu Business Line]

There has been a paradigm shift in the economic environment of our country too, so the need for a country-specific accounting standard has given way to a need for global or international accounting standards. In present scenario, the corporate entities are going for cross border businesses. You must be hearing about the multinational companies everyday in newspapers and other media. So, do you understand what huge amount of capitals will be required and raised by these companies and how these can change the economic prospects of all of us, you and me and all learned persons who are actually investing in these companies? Yes, it involves humongous amount of money and so we the users and our investors need to understand their working to put so much money in them. Well, we can just study the reports they present us and these reports better be based on an uniform standard which is followed by every country taking part in the world-wide trade and commerce.

The International Accounting Standards Board (IASB), has developed and issued the International Financial Reporting Standards (IFRS) which has been recognized as Global Reporting Standards. More than 120 countries like the European Union, Australia, New Zealand and Russia has either already adopted or permitted the IFRSs as a tool for financial reporting.

The Ministry of Corporate Affairs (MCA) has issued 39 converged Accounting Standards on 16th February, 2015. The list of Accounting Standards are given in the next page.

The list of these new standards are given below. It is called 'Ind-AS". However, the MCA has not notified the date from when these Ind-AS will be effective.

1. **Ind-AS : 1 Presentation of Financial Statements**
2. **Ind AS : 2 Inventories**
3. **Ind AS : 7 Statement of Cash Flows**
4. **Ind AS : 8 Accounting Policies, Changes in Accounting Estimates and Errors**
5. **Ind AS : 10 Events after the Reporting Period**
6. **Ind AS : 12 Income Taxes**
7. **Ind AS : 16 Property, Plant and Equipment**
8. **Ind AS : 17 Leases**
9. **Ind AS : 19 Employee Benefits**
10. **Ind AS : 20 Accounting for Government Grants and Disclosure of Government Assistance**
11. **Ind AS : 21 The Effects of Changes in Foreign Exchange Rates**
12. **Ind AS : 23 Borrowing Costs**
13. **Ind AS : 24 Related Party Disclosures**
14. **Ind AS : 27 Separate Financial Statements**
15. **Ind AS : 28 Investments in Associates and Joint Ventures**
16. **Ind AS : 29 Financial Reporting in Hyperinflationary Economies**
17. **Ind AS : 32 Financial Instruments: Presentation**
18. **Ind AS : 33 Earnings per Share**
19. **Ind AS : 34 Interim Financial Reporting**
20. **Ind AS : 36 Impairment of Assets**
21. **Ind AS : 37 Provisions, Contingent Liabilities and Contingent Assets**
22. **Ind AS : 38 Intangible Assets**
23. **Ind AS : 40 Investment Property**
24. **Ind AS : 41 Agriculture**
25. **Ind-AS : 101 First-time Adoption of Indian Accounting Standards**
26. **Ind AS : 102 Share-based Payment**
27. **Ind AS : 103 Business Combinations**
28. **Ind AS : 104 Insurance Contracts**
29. **Ind AS : 105 Non-current Assets Held for Sale and Discontinued Operations**
30. **Ind AS : 106 Exploration for and Evaluation of Mineral Resources**
31. **Ind AS : 107 Financial Instruments: Disclosures**
32. **Ind AS : 108 Operating Segments**
33. **Ind AS : 109 Financial Instruments**
34. **Ind AS : 110 Consolidated Financial Statements**
35. **Ind AS : 111 Joint Arrangements**
36. **Ind AS : 112 Disclosure of Interests in Other Entities**
37. **Ind AS : 113 Fair Value Measurement**
38. **Ind AS : 114 Regulatory Deferral Accounts**
39. **Ind AS : 115 Revenue from Contracts with Customers**

Obligation to comply with Indian Accounting Standards (Ind AS)

The Companies and their auditors shall comply with the Indian Accounting Standards (Ind AS) specified in Annexure to these rules in preparation of their financial statements and audit respectively, in the following manner, namely :

(i) any company may comply with the Indian Accounting Standards (Ind AS) for financial statements for accounting periods beginning on or after **1stApril, 2015**, with the comparatives for the periods ending on 31st March, 2015, or thereafter;

(ii) the following companies shall comply with the Indian Accounting Standards (Ind AS) for the accounting periods beginning on or after **1st April, 2016**, with the comparatives for the periods ending on 31st March, 2016, or thereafter, namely :

(a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of rupees five hundred crore or more;

(b) companies other than those covered by sub-clause (a) of clause (ii) of subrule (1) and having net worth of rupees five hundred crore or more;

(c) holding, subsidiary, joint venture or associate companies of companies covered by sub-clause (a) of clause (ii) of sub- rule (1) and sub-clause (b) of clause (ii) of sub- rule (1) as the case may be; and

(iii) the following companies shall comply with the Indian Accounting Standards (Ind AS) for the accounting periods beginning on or after **1st April, 2017**, with the comparatives for the periods ending on 31st March, 2017, or thereafter, namely :

(a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees five hundred crore;

(b) companies other than those covered in clause (ii) of sub- rule (1) and sub-clause (a) of clause (iii) of sub-rule (1), that is, unlisted companies having net worth of rupees two hundred and fifty crore or more but less than rupees five hundred crore.

(c) holding, subsidiary, joint venture or associate companies of companies covered under sub-clause (a) of clause (iii) of sub- rule (1) and sub-clause (b) of clause (iii) of sub- rule (1), as the case may be.

Provided that nothing in this sub-rule, except clause (i), shall apply to companies whose securities are listed or are in the process of being listed on SME exchange as referred to in Chapter XB or on the Institutional Trading Platform without initial public offering in accordance with the provisions of Chapter XC of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Explanation 1. **–** SME Exchange shall have the same meaning as assigned to it in Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Explanation 2. **–** 'Comparatives' shall mean comparative figures for the preceding accounting period.

Benefits of Achieving the Convergence with IFRSs

To understand the benefits of achieving the convergence with the IFRSs, you need to understand who or what are exactly the prime beneficiaries. The beneficiaries are:

1. The economy of our country
2. The investors
3. The industry
4. The accounting professionals

Let us now consider the advantages of having a uniform global accounting standard and regulatory framework from the viewpoint of all the above-mentioned aspects.

1. The Economy of Our Country

Globalization has given birth to lots of hope and scopes for the economic benefit of our country. With globalization and liberalization of policies, the entire world has taken the form of an economic village. Advent of Internet and the revolution in telecommunication has made it possible for businesses to reach out to foreign shores crossing borders. More and more countries are opening their doors to foreign investments and more and more markets are emerging to fulfill the capital needs as well as the end users or customers for the businesses. In such a situation, convergence of our accounting principles with an international standard is of vital importance. It helps the economy to:

- Expand.
- Be more dynamic.
- Be more strategic.
- Be more competitive
- Maintain the capital markets more efficiently.
- Encourage investment from foreign investors.
- Bring more foreign capital.

2. The Investors

Investors could be stated as the party most benefited by the convergence. They are the people to invest money into different companies and markets. So they are in need of relevant, reliable and comparable financial reports available at right time. They are taking the risks of investing money crossing not only geographic borders but also crossing different jurisdiction. Convergence with IFRSs will help them in:

- Acquiring relevant, reliable, comparable and timely information regarding businesses across the globe.
- Understanding the business opportunities better.
- Reducing cost of interpretation of different accounting standards for different countries.
- Gaining confidence.

3. The Industry

A global market with a global and standard regulatory framework gives tremendous thrust to the industry. A global market will bring more foreign capital and give boost to the country's economy. A globally accepted accounting standard will simplify the process of financial reporting which in turn will reduce cost. So if we list out the benefits, these are:

- More foreign investors.
- More foreign capital.
- Simplicity in financial reporting.
- Reduced cost of reporting.

4. The Accounting Professionals

Accounting professionals provide their services and expert knowledge to different business entities and enterprises. Presence of a global accounting standard will help in opening doors for our professionals to different parts of the world. You must have observed our engineers, doctors and technicians have gone to foreign countries and have done extremely well in all aspects of life. But it was not the case for our accounting professionals. India traditionally had followed her own 'Generally Accepted Accounting Principles' which was substantially different from other developed countries. It hindered the scope for our accounting professionals to sell their expertise and knowledge in these countries. With convergence to IFRSs they can:

- Provide their skills and knowledge in different parts of the world.
- Can provide recommendation in financial reporting to different MNCs and foreign companies both as professionals in industry or private practice.

List of Current Accounting Standards

AS– 1 : Disclosure of Accounting Policies
AS– 2 : Valuation of Inventories
AS– 3 : Cash Flow Statement
AS– 4 : Contingencies and Events Occurring After the Balance Sheet Date
AS– 5 : Net Profit or Loss for the Period, Prior Period Items and Change in Accounting Policies
AS– 6 : Depreciation Accounting
AS– 7 : Construction Contracts

AS– 9 : Revenue Recognition
AS–10 : Accounting for Fixed Assets
As–11 : Accounting for the Effects of Changes in Foreign Exchange Rates
AS–12 : Accounting for Government Grants
AS–13 : Accounting for Investments
AS–14 : Accounting for Amalgamation
AS–15 : Accounting for Retirement Benefits in the Financial Statements of Employees
AS–16 : Borrowing Costs
AS–17 : Segment Reporting
AS–18 : Related Party Disclosures
AS–19 : Accounting for leases
AS–20 : Earnings Per Share
AS–21 : Consolidated Financial Statements
AS–22 : Accounting for Taxes on Income
AS–23 : Accounting for Investments in Associates in Consolidated Financial Statement
AS–24 : Discounting Operations
AS–25 : Interim Financial Reporting
AS–26 : Accounting for Intangible Assets
AS–27 : Financial Reporting of Interests in Joint Ventures
AS–28 : Impairment of Assets
AS–29 : Provisions, Contingent Liabilities and Contingent Assets
AS–30 : Financial Instruments : Recognition and Measurement
AS–31 : Financial Instruments : Presentation
AS–32 : Financial Instruments : Disclosure

AS — 1 : Disclosure of Accounting Policies [Effective Date : 1st April, 1991]

Introduction

Accounting policies are the specific accounting principles and the methods of applying these principles adapted by an enterprise in preparing and presenting financial statements. For some type of transactions and events, an Accounting Standard provides alternative accounting principles and methods of accounting.

For example, a business enterprise is required to provide for depreciation on its fixed assets and also to value the stock at the end of each accounting period. There are, however, a number of alternative methods of providing for depreciation (e.g., Straight Line Method, Reducing Balance Method, etc.) or of valuing stock (e.g., FIFO, Weighted Average, etc.).

The other examples are:

» Treatment of expenditure during construction
» Conversion or translation of foreign currency items
» Treatment of goodwill
» Valuation of investments
» Treatment of retirement benefits
» Recognition of profit on long-term contracts
» Valuation of fixed assets
» Treatment of contingent liabilities.

Since there is no list of accounting policies which are applicable to all circumstances, the accountant should evaluate the appropriateness of accounting policies employed by management. An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions. In the absence of a standard of an interpretation that specifically applies to a situation of diverse and complex economic activity, management shall use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable.

Fundamental Accounting Assumptions

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

The following have been generally accepted as fundamental accounting assumptions:

(a) Going Concern
(b) Consistency
(c) Accrual

Going Concern

Unless otherwise stated, the users of financial statements assume that the enterprise is a going concern, and it will continue operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Consistency

Unless otherwise stated, the users of financial statements assume that there is no change in the accounting policies from one period to another.

If it is necessary to change the method being employed, then an explanation of the change and the effects it is having on the results must be disclosed for the benefit of the users of financial statements.

For example, X Ltd. charging depreciation following straight line method for last 5 years (2009-10 to 2013-14). The users of financial statements will assume that the straight line method of depreciation has been adapted at the time of preparation of financial statements for the year 2014-15 also.

Accrual

Unless otherwise stated, the users of financial statements assume that the financial statements have been prepared on accrual basis. Under accrual basis of accounting revenues and costs are recognised as they are earned or incurred, not as money is received or paid.

Example 1 : X Ltd. sold goods of ₹ 10,00,000 on 20th March, 2014. Credit term — one month. At the time of preparing financial statements for the period 2013-14, this revenue from sale of ₹ 10,00,000 will be recognised in the accounts of 2013-14, though cash will be received in the next financial year.

Example 2 : X Ltd has received electricity bill for the month of March 2014. The due date for payment is 10th April, 2014. As the electricity bill is related to accounting year 2013-14, it should be recognised as expenses for the year 2013-14, though the payment to be made in the next financial year.

Considerations in the Selection of Accounting Policies

The primary consideration in the selection of Accounting Policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the Balance Sheet date and of the profit or loss for the period ended on that date. For this purpose, the major considerations governing the selection and application of accounting policies are:

Prudence

Future is always uncertain. Many times, accountants are faced with uncertainties in estimating and judging some items at the time of preparation of financial statements. In these situations the accountants look to the concept of prudence / conservatism.

This concept requires that assets and profits should not be overstated and revenue should never be anticipated at the time when the financial statements are prepared. Revenue can only be recorded in the books of account when there is a reasonable certainty about its realisation. At the same time, provision must be made for all possible liabilities. It is not important whether the amount of liability is known with certainty or is based on estimation. To illustrate, inventories are recorded at their cost or Net Realisable Value (NRV), whichever is lower. Likewise, if there is an anticipation that a debt may not be realised, a specific amount is set aside from profit as a provision for doubtful debts. This concept is expressed as : "Recognise all losses and anticipate no gains". This concept attempts to state the *lowest likely value* of assets and profits, and the *highest likely amount* of any losses or liabilities incurred.

Substance over Form

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form. In accounting, substance should normally take *precedence* over form in deciding how a particular transaction should be recorded. The legal form of a transaction is frequently descriptive of its economic substance. However, the form occassionally misrepresents the characteristics that are relevant to users. If the substance can be reliably determined, the accountant should describe the transaction in terms of the substance rather than the form. Accounting for hire-purchase transactions, for example, is based on the above concept, i.e., it looks at the substance of the transaction rather than its legal form. The hire-purchaser can record the asset at its cash down price, while paying for it by installments over an agreed period of time.

Materiality

Financial statements should disclose all material items. An item is material if the user would have done something differently if he or she had not known about the item. The accountants are often faced with decisions about small items or events that make little difference to users of financial statements no matter how they are handled. For example, Reliance Industries Ltd. may decide that expenditure for utensils in Workers' Canteen should be charged as expenses rather than recorded as long-term assets and depreciated.

Disclosure of Accounting Policies

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

Such disclosure should form part of the financial statements. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

Any change in the accounting policy which may have a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

OBJECTIVE TYPE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Disclosure of fundamental accounting assumptions are :
   A necessary if they are followed at the time of preparation of financial statements
   B necessary if they are not followed at the time of preparation of financial statements
   C none of the above

2. What does the going concern mean ?
   A a business is profitable
   B a business will continue to operate for the foreseeable future
   C the assets of a business exceed its liabilities
3. A very large company has prepared financial statements without including very small items of furniture in its fixed assets. What accounting concept has the company applied ?
   A prudence
   B consistency
   C materiality
4. Two companies buy identical computer equipment. The large company writes it off immediately, but the smaller company treats it as a fixed asset. Which accounting concept are the companies applying ?
   A going concern
   B materiality
   C consistency
5. Which is an example of the prudence concept ?
   A only items with a monetary value are included in accounting
   B accrued expenses are charged to profit and loss account
   C profit is not over-stated
6. Which of the following statements explain prudence concept most closely ?
   A All legislation and accounting standards have been complied with
   B Understatement of assets or gains and overstatements of liabilities or losses
   C The application of a degree of caution in exercising judgment under conditions of uncertainty
7. Which of the following statements is / are correct ?
   (1) In order to achieve comparability it may sometimes be necessary to override the prudence concept.
   (2) Substance over form is an accounting concept whereby transactions and other events are accounted for and presented in accordance with their economic reality rather than legal form.
   A both (1) and (2)
   B (1) only
   C (2) only
8. A company purchases a machinery on hire purchase over four years but does not own the machinery until the final payment has been made. At the end of year 1, the company shows the machinery in its Balance Sheet as a fixed asset and also records the liability for the amount still owed. Which accounting concept is being applied ?
   A going concern
   B substance over form
   C prudence

Guide to Answers

1. B; 2. B; 3. C; 4. B; 5. C; 6. C; 7. C; 8. B.

Some of the Accounting Standards have been discussed in detail in Appendix — A.

APPENDIX — A

AS — 2 : Valuation of Inventories (Revised)

[Effective Date : 1st April, 1999]

Introduction

Inventory is one of the largest assets of a business enterprise. It ranges from 25% to 30% of the total assets of the enterprise. The major source of revenue is the sale of these inventories. The objective of accounting for inventories is the proper determination of income through process of matching appropriate cost against revenues.

To ascertain the trading profit of a particular period, revenues for the period must be matched or set off by all the related expenses in producing those revenues. Proper inventory accounting will help to determine what portion of the cost of goods available for sale should be deducted from the revenues of the current period and what portion is to be carried forward as inventory to be matched against revenues in the next 'accounting period'.

Objectives and Scopes

This Standard covers accounting and disclosure of inventories. It prescribe the accounting treatment for inventories, including cost determination and expense recognition.

However, this Standard does not cover the following :

(a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) - 7, Accounting for Construction Contracts);
(b) work in progress arising in the ordinary course of business of service providers;
(c) shares, debentures and other financial instruments held as stock in trade; and
(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

Meaning of Important Terms

Inventories

Inventories are assets

(a) held for sale in the ordinary course of business (e.g., finished car ready to be despatched to dealers);
(b) in the process of production for such sale (e.g., car in the assembly lines); or
(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services (e.g., tyre, battery, headlights, etc.).

Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular, e.g., spray guns used in the 'paint shop' of an automobile company's workshop.

Net Realisable Value (NRV)

Net realisable value is the estimated selling price, in the ordinary course of business, less cost of completion, and the estimated cost necessary to make the sale.

Illustration 1

X Ltd. has an item in stock which cost ₹ 10,000 and can be sold for ₹ 12,000. However, before it can be sold, it will require to be modified at a cost of ₹ 1,500. The expected selling expenses of the item are an additional ₹ 1,000. Calculate the Net Realisable Value (NRV) of the item.

Solution

NRV = Selling Price – Modification Cost – Expected Selling Expenses
= ₹ 12,000 – 1,500 – 1,000 = ₹ **9,500**.

Fair Value

Fair value is the value for which an item could be sold between willing independent traders.

For example, X has a contract to supply 100 quintals of sugar to a biscuit manufacturing company @ ₹ 1,300 per quintal. The price is fixed for 3 months, January to March, 2015. At the end of January the market price of sugar is ₹ 1,400 per quintal. X buys 100 quintals at the market price, i.e., ₹ 1,400 per quintal. Here, fair value is ₹ 1,400 and Net Realisable Value is ₹ 1,300 less selling cost.

Measurement of Inventories

Inventories should be valued at the ***lower of cost and net realisable value***.

Illustration 2

The following information is available from the books of account of a trader. Stock which cost ₹ 20,000 can now be replaced for ₹ 14,000. The estimated net realisable value of this stock is ₹ 17,000. It is proposed that the stock should be written down to ₹ 17,000. Give your view.

Solution

As per AS—2, inventories should be valued at cost or NRV whichever is lower. Here, cost is ₹ 20,000 and NRV is ₹ 17,000. Therefore, stock should be valued at ₹ 17,000 being the lowest. ***Replacement value will not be taken into consideration***.

Cost of Inventories

For valuation of inventories, the determination of ***cost*** is very important. The cost of inventories should comprise:

(i) all costs of purchase;
(ii) costs of conversion; and
(iii) other costs incurred in bringing the inventories to their present location and condition.

Costs of Purchase : The costs of purchase consists of the purchase price including duties and taxes (other than those can be reclaimed from the authorities), freight inwards and other expenditure directly attributable to the acquisition (e.g., brokerage on purchase, packing cost for transportation, etc.).

Trade discounts, rebates, duty drawbacks and other similar items are deducted from cost.

Illustration 3

Pepsi India Ltd. purchased 20,000 kgs. of oranges from farmers of Hosierpur, Punjab @ ₹ 10 per kg. Orange collecting agents' commission were paid @ ₹ 1 per kg. ₹ 8,000 were paid for lorry hire charges for transporting it to Noida Plant. 5% of the oranges were damaged in transit and discarded. This loss is a normal loss. Calculate the cost of purchase per kg. of orange.

Solution

	₹
(i) Purchase Price (20,000 × ₹ 10)	2,00,000
(ii) Collecting agents' commission (20,000 × ₹ 1)	20,000
(iii) Transportation cost	8,000
Total Cost of (20,000 – 1,000) = 19,000 kgs.	2,28,000

$$\text{Purchase cost per kg.} = \frac{2,28,000}{19,000} = ₹\ 12.$$

Costs of Conversion : The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting raw materials into finished goods.

For example, Wills Ltd. is having a readymade garment factory in Ludhiana, Punjab, where two products are manufactured — sports T-shirt and Track suit. Direct labour hours of 24,000 are used in each period. Cutting is done by computer controlled automatic machine. However, stitching is done manually. Workers are paid ₹ 50 for stitching one T- shirt and ₹ 100 for stitching one Track suit. At the time of calculating cost of T-shirt ₹ 50 is to be added and for calculating cost of Tract suit ₹ 100 to be added.

Fixed production overheads are those indirect cost of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance cost of cutting machine in the above example, depreciation of factory building and the cost of factory management and administration.

The allocation of fixed production overheads for the purpose of their inclusion in the cost of conversion is based on the ***normal capacity*** of the production facility. This is the average expected output over a number of periods, taking into account production reductions due to planned maintenance and normal holidays.

For example, before Diwali you close the factory for routine maintenance and cleaning. You follow 5 days a week and single shift each day. At the time of calculating normal capacity all these factors must be taken into consideration. It should not be calculated on the basis of calendar days.

Low production levels, or idle plant for abnormal reasons are not taken into consideration in determining the allocation rate of fixed production overheads.

For example, productions were suspended for 4 weeks for flood. The fixed production overheads incurred during that time should not be included in the cost of inventory.

Unallocated overheads are recognised as an ***expense*** in the period in which they are incurred. In periods of abnormally-high production, the overhead allocation rate is ***reduced***, so that, inventories are not measured above cost.

For example, Normal output of your factory is 20,000 units per month. You normally charge fixed overhead per unit @ ₹ 20. To complete a special order from China, your factory works overtime every weekends for last 4 months. The new level of output is 25,000 units per month.

Total fixed overhead per month = ₹ 20 × 20,000 = ₹ 4,00,000.

Under changed circumstances, the fixed overhead rate will be reduced :

$$\text{New Rate} = \frac{4,00,000}{25,000} = ₹\ 16$$

Variable production overheads are those indirect costs which vary directly or near directly, with the volume of production, such as indirect materials, indirect labour etc.

Variable production overheads are assigned to each unit of production on the basis of actual use of the production facilities.

For example, Wills Ltd.'s ready made garment factory has a centralised ironing facility. It cost ₹ 300 per productive hours to run.

T-shirt takes 1 minute and Track suit takes 2 minutes for ironing.

Therefore, variable production overhead to be assigned to T-shirt = ₹ 5 $\left(\frac{300}{60} \times 1\right)$ **and**

Track suit = ₹ 10 $\left(\frac{300}{60} \times 2\right)$

Joint Products and By-products

A production process may result in more than one product being produced simultaneously.

When a group of individual products is simultaneously produced, and each product has a significant relative sales volume, the outputs are usually called ***Joint Products***.

Those products which are part of the simultaneous production process and have a minor sales volume or insignificant sales volume are called ***by-products***.

In case of joint products, when the costs of conversion of each product are not separately identifiable, they are allocated between products on a rational and consistent basis. The joint cost may be allocated on the basis of relative sales value of each product, either when they complete or when they are separately identifiable in the production process.

For example, Haldia Petrochemicals Ltd. incurs per batch joint product cost of ₹ 30,00,000 for the production of two joint products X and Y. Both products can be sold at split-off point. X can be sold @ ₹ 80 per unit and Y can be sold @ ₹ 40 per unit. The production were — X 50,000 units and Y 50,000 units.

In this case, the joint cost of ₹ 30,00,000 will be allocated as follows :

Joint Product Cost — ₹ 30,00,000		**Sale of 50,000 units @ ₹ 800**	**40,00,000**
		Sale of 50,000 units @ ₹ 400	**20,00,000**
	Split-off point	**Total Sales**	**60,00,000**

(i) Product X should bear 2/3 of ₹ 30,00,000	**₹ 20,00,000**
(ii) Product Y should bear 1/3 of ₹ 30,00,000	**₹ 10,00,000**
	₹ 30,00,000

Each unit of X will bear ₹ 40 (₹ 20,00,000 / 50,000)

Each unit of Y will bear ₹ 20 (₹ 10,00,000 / 50,000)

Most by-products as well as scrap or waste materials, by its nature, is immaterial. If this is the case, then it is measured at net realisable value, and this value is deducted from the cost of the main product.

Other Costs : Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

These would include inward transport and storage cost prior to completion of production or the cost of designing products for specific customers.

It should be noted that interest and other borrowing costs are not included in the cost of inventories.

Excise Duty on Finished Goods

Excise duty is a manufacturing expense and therefore, it should be included in the valuation of finished goods. The Guide Note on "Accounting Treatment for Excise Duty" issued by the Institute of Chartered Accountants of India is very important in this respect and it is given below :

"Since the liability for excise duty arises when the manufacture of the goods is completed, it is necessary to create a provision for liability of unpaid excise duty on stock lying in factory or bonded warehouse. The estimate of such liability can be made at the rate in force on the Balance Sheet date. The excise duty paid provided on finished goods should, therefore, be included in the inventory valuation."

It should be noted that if the excise duty is refundable, it should not be included in the cost of raw materials consumed to produce the W.I.P. or the finished goods.

Cost Excluded from Inventories

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

(a) abnormal amounts of wasted materials, labour or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

Illustration 4

(i) When valuing stock at cost, which of the following shows the correct method of arriving at cost ?

	Include inward transport cost	Include production overheads
A	YES	NO
B	NO	YES
C	YES	YES
D	NO	NO

(ii) According to AS – 2 (Inventories), which of the following costs should be included in valuing the inventories of a manufacturing company ?

(i) carriage inwards
(ii) carriage outwards
(iii) depreciation of factory plant
(iv) general administrative overheads
A all four items
B (i), (ii) and (iv) only
C (i), (iii) and (iv) only
D (i) and (iii) only

Solution

(i) At the time of valuation of stock at cost, inward transparent cost as well as production overheads are to be included. Therefore, answer "**C**" is correct.

(ii) For determining the cost of inventories, carriage inwards and depreciation of factory plant are to be taken into consideration. However, carrying outwards and general administrative overheads will not be taken into consideration. Therefore, answer "**D**" is correct.

Illustration 5

Which of the following costs may be included when arriving at the cost of finished goods inventory for inclusion in the financial statements of a manufacturing company ?

(i) carriage inwards
(ii) carriage outwards
(iii) depreciation of factory plant
(iv) finished goods storage costs
(v) factory supervisor’s salary
A all five
B (i) and (v) only
C all except (iv)
D all except (ii) and (iv)

Solution

For calculating cost of finished goods inventory, carriage inwards, depreciation of factory plant and factory supervisor’s salary are included. However, carriage outwards and finished goods storage cost are excluded. Therefore, answer "**D**" is correct.

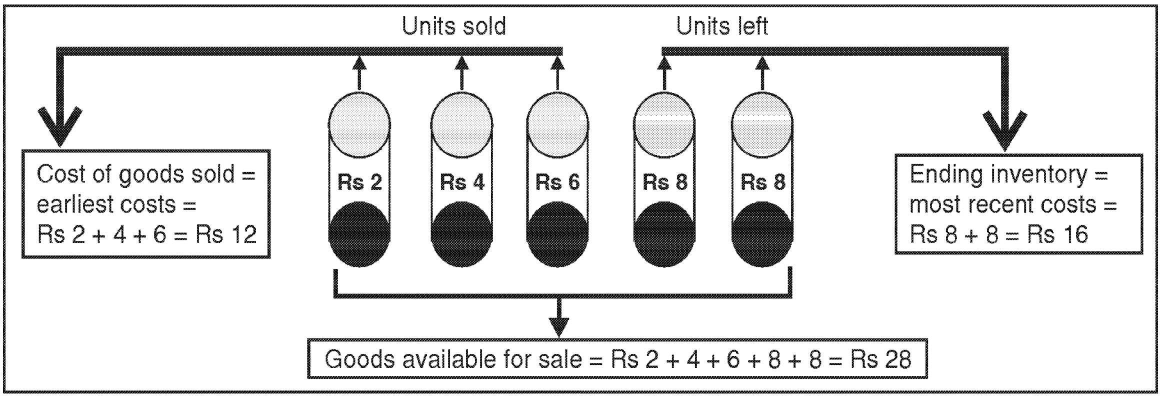
Cost Formulas

Inventory prices are seldom stable. In many cases inventories lose their identity and are substantially indistinguishable from one another, though may be acquired at varying rates. A very important valuation problem arises while assigning costs to inventory items. No problem would arise if prices never changed. Once the unit cost of each inventory item is known, some method must be used to assign costs to closing inventory and cost of goods sold. There are several methods for assigning cost to inventory items.

1. Specific Identification Method This method is adapted by the enterprises to determine the cost of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects. For example, X Ltd. deals in paintings of renowned artists. As the paintings are not interchangeable, X Ltd. should follow 'Specific Identification Method' for valuation of closing inventory and cost of goods sold.

2. First In First Out Method (FIFO) This method is based on the premise that the first item purchased is the first item sold, that is, all the inventories are sold in the order in which they are acquired. Since the oldest stock in the inventory is sold first, the calculation of the inventory is on the basis that the inventories in hand represent the ones most recently purchased or produced and the cost of goods sold represents the cost of items acquired in the earlier purchases.

FIFO METHOD

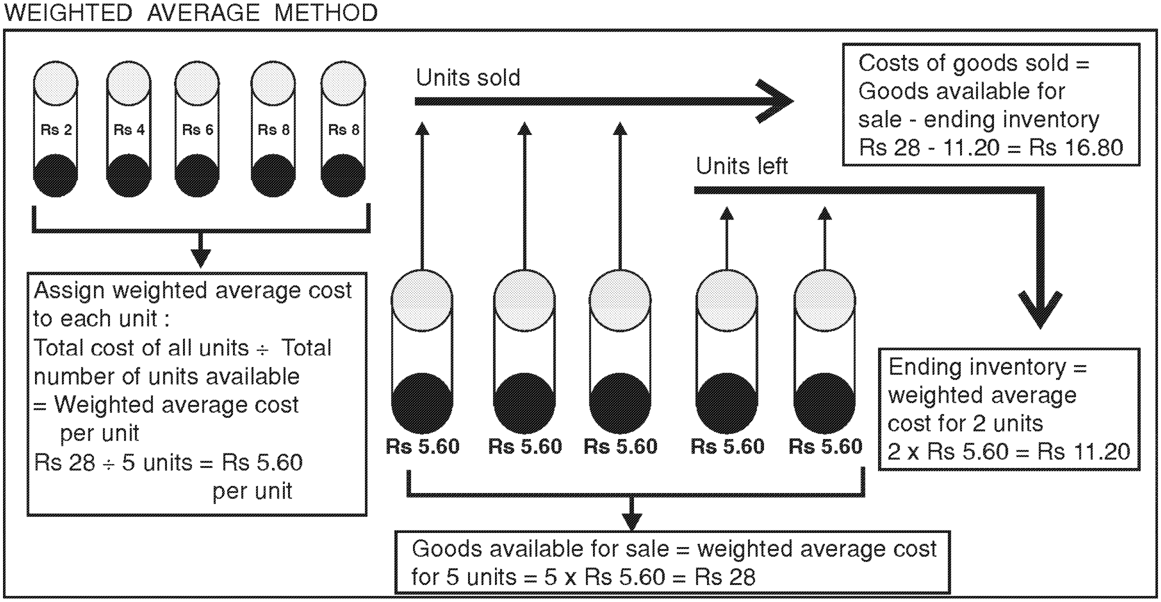


3. Weighted Average Method Under this method, the costs to be assigned to inventories are ascertained by applying to the closing inventory an average cost computed by dividing the total cost of units by the total number of such units. The average cost is calculated by applying the following formula:

$$\text{Weighted Average Cost Per Unit} = \frac{\text{Opening Inventory} + \text{Purchases (in amount)}}{\text{Opening Inventory} + \text{Purchases (in units)}}$$

The value of the closing inventory is ascertained by multiplying the number of units on hand (from the physical count) by the weighted average cost per unit (see the diagram below).

WEIGHTED AVERAGE METHOD



Techniques for the Measurement of Cost — Standard Cost Method and the Retail Method

Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method may be used for convenience if the results approximate the actual cost.

Standard Cost Method: Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

The Retail Method: The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing method. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Net Realisable Value (NRV)

Inventories should not be carried in excess of amounts expected to be realised from their sale or use. It may be necessary to write down the cost of the inventory to NRV for different reasons, e.g.,

(i) Damage to the inventories
(ii) Obsolescence
(iii) General decline in the market price for the goods
(iv) Estimated costs necessary to make the product saleable

For calculating NRV, the following points are to be taken into consideration :

1. Review Items Individually

Inventories are usually written down to net realisable value on an ***item-by-item*** basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

Illustration 6

Lexus Motors Ltd. a dealer in second hand cars has 5 vehicles in stock at the end of the financial year 2014-15. These are :

Car	Fiat	Ambassador	Maruti Esteem	Maruti 800	Zen	Total (₹)
Cost (₹)	90,000	1,15,000	2,75,000	1,00,000	2,00,000	7,80,000
Net Realisable Value (₹)	95,000	1,55,000	2,65,000	1,25,000	2,30,000	8,70,000

You are required to calculate the value of stock to be included in the Balance Sheet of the company.

Solution

For calculating the value of stock, each item is to be reviewed individually. The valuation of stock is to be done as follows :

Car	Fiat	Ambassador	Maruti Esteem	Maruti 800	Zen	Total (₹)
Value (₹)	90,000	1,15,000	2,65,000	1,00,000	2,00,000	7,70,000

It should be noted that the appropriate stock figure is not ₹ 7,80,000 but ₹ 7,70,000 as calculated above.

Illustration 7

As at 31st December, 2014 the original cost of stock held by A amounted to ₹ 6,345 whilst the total net realisable value of this stock was estimated at ₹ 7,894 — A has analysed these figures as follows :

Item	Cost (₹)	Net Realisable Value (₹)
Readymade Garments	3,169	3,078
Clothing	2,789	4,157
Undergarments	387	659
	6,345	7,894

You are required to value the Stock as per AS—2.

Solution

At the time of valuation of stock, cost and net realisable value of each item is to be considered ***separately***. The value of stock as per AS—2 will be as follows :

Item	Cost (₹)	Net Realisable Value (₹)	Value to be taken (₹)
Readymade Garments	3,169	3,078	3,078
Clothing	2,789	4,157	2,789
Undergarments	387	659	387
Value of Stock			6,254

2. Contract Price and Market Price

Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices.

For example, X Ltd. purchased 10,000 barrels of crude oil @ ₹ 4,400 per barrel. At the end of the period, it has a contract to sell 10,000 barrels @ ₹ 4,000 per barrel. However, the market price is ₹ 3,600 per barrel at the year end.

Here, for the purpose of calculating net realisable value, the contract price ₹ 4,000 per barrel is to be taken into consideration. The value of stock will be : 10,000 × ₹ 4,000 = ₹ **400,00,000**.

Taking the above example, let us assume that X Ltd. has a contract to sell 9,000 barrels @ ₹ 4,000 per barrel. Here net realisable value is to be calculated as follows :

9,000 @ ₹ 4,000 per barrel	₹ 360,00,000
1,000 @ ₹ 3,600 per barrel	₹ 36,00,000
Total	₹ 396,00,000

Illustration 8

X Limited has purchased 1,00,000 units of a product @ ₹ 800 per unit on 1.1.2015. On the Balance Sheet date, i.e., 31.3.2015 there were 20,000 units in stock. Of these, 5,000 units are earmarked against sale contract at a price of ₹ 900 each. The market price of the product has dropped to ₹ 750. How the closing stock will be valued on 31.3.2015 ?

Solution

The inventory will be valued as under :	₹
Inventory held against contract 5,000 × (lower of ₹ 800 and ₹ 900)	40,00,000
Inventory held for resale 15,000 × (lower of ₹ 800 and ₹ 750)	1,12,50,000
Total value of inventory	1,52,50,000

3. No write down when finished goods will be sold at cost or above cost

Materials and other supplies held for use in 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 NRV, the materials are written down to NRV. In such circumstances, the replacement cost of the materials may be the best available measure of their NRV.

Illustration 9

Stock consists of 1,742 units of a raw material purchased at ₹ 7.30 each, but the unit price of the item has fallen to ₹ 6.50. The price reduction is apprehended to be permanent. The firm has already decided that if the price reduction last longer than six months, it will reduce the sale price of the finished goods from ₹ 10.90 to about ₹ 10.

Calculate the Value of Stock.

Solution

In this case, though the unit price has fallen to ₹ 6.50 from ₹ 7.30, the stock will be valued @ ₹ 7.30 because it will not exceed the revised selling price of ₹ 10.

Therefore, the value of stock will be : 1,742 × ₹ 7.30 = ₹ **12,716.60**.

Illustration 10

X Limited uses a single raw material and converts that into a finished product. During the year ended 31.3.2014, the manufacturing cost of the product was as follows:

		₹
Raw materials — 4 units @ ₹ 10 each		40
Conversion cost		30
	Manufacturing cost	70

The finished product is sold @ ₹ 85 per unit.

On 31.3.2014, there was a fall in the sale price of the finished product to ₹ 60, because of steep fall in the raw material prices. Currently, raw materials are available in the market @ ₹ 5 each. On 31.3.2014, there was 50,000 units of raw materials in stock purchased at the above rate.

Calculate the value of inventory on 31.3.2014.

Solution

In this case manufacturing cost is ₹ 70 but the sale of finished goods has fallen to ₹ 60, because of decline of the raw material price from ₹ 10 to ₹ 5. Inventories to be valued at net realisable value.

In this circumstances, the replacement cost of the material may be the best available measure of its net realisable value.

Therefore, the value of closing stock on 31.3.2008 will be : 50,000 × ₹ 5 = ₹ **2,50,000**.

Disclosure

The financial statements should disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used; and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

General Illustrations

Illustration 11

DCM Ltd manufactures textiles. The company accountant asks your advice about the following product lines:

Lime Green Tartan : Manufactuing cost ₹ 9,000. This stock has been on a shelf since 2000. The accountant believes that the only way of selling it would be to shred it and bundle it (at a cost of ₹ 500) and sell it as industrial cleaning wipes for an anticipated sale price of ₹ 5,000.

Power Strangers : Originally printed to meet a high demand for garments linked to a popular television serial, there is no further demand for the textile in this country. Stocks cost ₹ 16,000, and the only possible source of revenue would be to export the material at a cost of ₹ 2,750 for use as dusters in Australia. Administration costs to handle the sale are estimated at ₹ 2,650, and the sale price is estimated at ₹ 4,000.

Explain, with reasons, how each of the above product lines should be accounted for in the annual accounts of the company for the year ended 31 March, 2015.

Solution

Inventories should be valued at the lower of cost and net realisable value.

Lime Green Tartan : Manufacturing cost is ₹ 9,000 but the net realisable value is ₹ 4,500 (₹ 5,000 – ₹ 500). Therefore, ₹ 4,500 is to be taken as value of stock for annual accounts of the company.

Power Strangers : Cost is ₹ 16,000 but the net realisable value is negative (₹ 4,000 – ₹ 2,750 – ₹ 2,650). Therefore, the value of stock should be taken as nil.

Illustration 12

X Limited has three major categories of goods: X, Y and Z. The following information is available on 31.3.2014 in respect of these (figures in ₹):

Items	Historical Cost	Replacement Cost	Net Realisation Value
X	50,000	53,000	37,000
Y	65,000	60,000	64,000
Z	50,000	54,000	72,000

Calculate the value of inventory as on 31.3.2015.

Solution

Inventories are valued at lower of historical cost or net realisable value. Replacement cost is relevant when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. Therefore, the inventory will be valued as under:

Item	Amount (₹)
X	37,000
Y	64,000
Z	50,000
Total value of inventory	1,51,000

Illustration 13

The company deals in three products A, B and C, which are neither similar nor interchangeable. At the time of closing of its accounts for the year 2014-15, the Historical Cost and Net Realisable Value of the items of closing stock are determined as follows :

Items	Historical Cost (₹ in Lakhs)	Net Realisable Value (₹ in Lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of closing stock ? ***[C.A. (PE-II) — May, 2004]***

Solution

As per para 5 of AS—2, inventories should be valued at the lower of cost and net realisable value.

As per para 14 of AS—2, the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

As per para 21 of AS—2, inventories are usually written down to net realisable value on an item-by-item basis.

Statement Showing the Calculation of Closing Stock (figures in Lakhs)

Items	Historical Cost	Net Realisable Value	Valuation of Closing Stock
A	40	28	28
B	32	32	32
C	16	24	16
Total	88	84	76

Therefore, the value of closing stock is ₹ 76,00,000.

Illustration 14

X Ltd has included in its accounts an item of stock which had cost it ₹ 50,000. The business has no further use for this stock. It can be scrapped for ₹ 25,000 or sold for the following (all figures in ₹):

Sale Proceeds	40,000
Less: Trade discount	4,000
	36,000
Less: Cash discount	1,000
	35,000
Less: Cost of disposal	2,500
	32,500

What figure should be included in the accounts for this item ?

Solution

Cost — ₹ 50,000

Net Realisable Value	₹	
Sale Proceeds	40,000	∴ Lower of cost and net realisable value = ₹ 33,500. Therefore, ₹ 33,500 is to be included in accounts for this item. It should be noted that cash discount would appear in the Profit and Loss Account.
Less: Trade discount	4,000	
	36,000	
Less: Cost of disposal	2,500	
	33,500	

Illustration 15

How do you value the closing stock under the following situation?

Closing stock consists of 4,800 units purchased @ ₹ 5 each. At the year end, the firm realised that the closing stock is not that it would choose to acquire the market place. An equivalent product is available in the market which can be acquired @ ₹ 4 each. In effect, the firm has to reduce the selling price of the product from ₹ 6.25 to ₹ 4.75. The closing stock, in its present physical form, can be sold in the market @ ₹ 2.25 each. If the firm wants to replace the existing stock by the new equivalent product, it has to pay an additional amount of ₹ 1.50 per unit.

Solution

The firm has the following two options:

(i) To sell the stock at ₹ 2.25 each and re-acquire the stock at ₹ 4 each. In this case, it has to incur an additional cost of ₹ 1.75 (₹ 4.00 – ₹ 2.25) per unit.

OR

(ii) To replace the stock by paying at ₹ 1.50 per unit.

Obviously, the second option is cheaper. Therefore, the value of the stock = 4,800 × (₹ 4.00–1.50) = ₹ **12,000**.

Illustration 16

The Directors of ITC Limited have valued their stocks at ₹ 4,50,000 at 31 December, 2014. Some of the stock items have been drawn to the attention of the company's auditors :

(i) Two categories of stocks, VX and LX have been valued at ₹ 23,000. The auditors ascertain that the valuation was based on what the directors considered was the lower of cost and net realisable value, calculated as follows:

Item		Cost of Raw Materials [1]	Attributable Production Overheads Incurred [2]	Attributable Distribution Overheads to be Incurred [3]	Expected Selling Price [4]
VX	(₹)	16,000	2,000	2,400	17,000
LX	(₹)	4,000	1,000	2,000	8,000
	(₹)	20,000	3,000	4,400	25,000
Cost	{ [1] + [2] }	→ 23,000			
Net Realisable Value	{ [3] + [4] }	→ 29,400			

(ii) A raw material, Opprobrium, was bought at several different prices during the year, and the closing stock was valued at ₹ 44,000. The stock has previously been valued on a FIFO basis. Stock is valued on a periodic basis. Details of the stock are :

Month	Received (Tonnes)	Cost per Tonne (₹)	Issues (Tonnes)
Jan.	500	35	200
Mar.	300	45	500
Jun.	600	65	400
Nov.	800	90	100

There were no stocks of Opprobrium on 1 January, 2014.

You are required to recalculate the value of ITC Limited's Closing Stock at 31 December on the basis of AS—2.

Solution

(i) As per Para 21 of AS—2, '***Inventories are usually written down to net realisable value on an item-by-item basis***.' Therefore, at the time of valuation of stock, cost and net realisable value of each item is to be considered separately. The value of stock as per AS—2 will be as follows :

Item	Cost [Note 1] (₹)	NRV [Note 2] (₹)	Value to be taken (₹)
VX	18,000	14,600	14,600
LX	5,000	6,000	5,000
Value of Stock			19,600

Working Notes :

(1) Calculation of Cost

Item	VX (₹)	LX (₹)
Cost of Raw Materials	16,000	4,000
Add: Attributable Production Overhead	2,000	1,000
Cost	18,000	5,000

(2) Calculation of Net Realisable Value (NRV)

Item	VX (₹)	LX (₹)
Expected Selling Price	17,000	8,000
Less: Attributable Distribution Overhead to be Incurred	2,400	2,000
NRV	14,600	6,000

(ii) As per Para 16 of AS—2, the cost of Inventories should be assigned by using FIFO, or Weighted Average Cost Formula. The company is using FIFO method. Therefore, FIFO method is to be adopted to determine the cost of raw materials — 'Opprobrium'.

Total Quantity Received	2,200 (tonnes)
Total Issue	1,200 (tonnes)
Quantity in hand	1,000 (tonnes)

Cost of Closing Inventory is Calculated as Under	₹
800 (tonnes) @ ₹ 90	72,000
200 (tonnes) @ ₹ 65	13,000
1,000	85,000

Therefore, the cost of stock will be ₹ 85,000

Revised Value of Stock

Particulars	₹	₹
Value of Stock (as determined by the Directors)		4,50,000
Adjustment for Change in the Value of VX, LX and Opprobrium :		
(i) Reduction in the value of VX + LX (₹ 23,000 – ₹ 19,600)	(3,400)	
(ii) Increase in the value of Opprobrium (₹ 85,000 – ₹ 44,000)	41,000	37,600
Revised Value of Stock		4,87,600

Illustration 17

State with reference to Accounting Standard, how will you value the inventories in the following cases:

(i) Raw materials were purchased at ₹ 100 per kilo. Price of the raw material is on decline. Finished goods in which raw materials were incorporated are expected to be sold at below cost. 10,000 kg of raw materials are on stock at the year end. Replacement cost is ₹ 80 per kg.

(ii) In a production process, normal wastage is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste is on stock at the year end.

(iii) Per kg. of finished goods consisted of:
Material cost ₹ 100 per kg.
Direct labour cost ₹ 20 per kg.
Direct variable production overhead ₹ 10 per kg.
Fixed production charges for the year on normal capacity of one lakh kg. is ₹ 10 lakh. 2,000 kg. of finished goods are in stock at the year end.

Solution

(i) As per para 24, when there has been a decline in the prices of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

Therefore, in this case, the materials will be valued at ₹ 80 per kg. Total value ₹ 8,00,000.

(ii) Input : 5,000 MT; Normal wastage : 5%, i.e., 5% of 5,000 MT = 250 MT.

Actual wastage : 300 MT; Abnormal wastage 300 MT – 250 MT = 50 MT.

As per para 13, in determining the cost of inventories, it is appropriate to exclude abnormal amounts of wasted materials or expenses in the period in which they are incurred.

Therefore, in this case, the entire cost of abnormal wastage, i.e., 50 × ₹ 1,000 = ₹ 50,000 should be charged to the Profit and Loss Account.

(iii) As per para 9, the allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Therefore, in this case, the cost per kg. of finished goods will be calculated as under:

	₹
Materials	100
Direct labour	20
Direct variable production overheads	10
Fixed production overheads	*10
	140

$$\text{Fixed production overheads per kg.} = \frac{\text{Rs } 10{,}00{,}000}{1{,}00{,}000} = \text{Rs } 10 \text{ per kg.}$$

Therefore, the value of 2,000 kg. of finished goods = 2,000 × ₹ 140 = ₹ 2,80,000.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Which of the following is correct ?
   A Inventories are assets held for use in the construction of the building, e.g., air conditioners
   B Inventories are assets held for sale in the ordinary course of business
   C Inventories includes machinery spares which is used irregularly
2. Net realisable value is
   A the estimated selling price *plus* cost of completion *minus* selling expenses
   B the estimated selling price *less* cost of competition
   C the estimated selling price in the ordinary course of business, *less* cost of completion less selling expenses
3. The purchase price, transport and handling cost, tax and import duties are all examples of
   A cost of purchase
   B cost of conversion
   C cost of purchase, cost of conversion and other costs
4. The cost of inventories should comprise
   A cost of purchase, cost of conversion and other cost like interest
   B cost of purchase, cost of conversion and other cost like post manufacturing storage cost
   C cost of purchase, cost of conversion and other cost like primary packing cost
5. Standard Costs Method or the Retail Method is used as a tool of measurement of cost. Retail Method is
   A sale price plus mark up
   B sale price less gross margin
   C none of the above

6. Reasons for inventories being sold for less than their cost could be:
   (i) Damage to the inventories and obsolescence
   (ii) General fall in the market price of the goods
   (iii) Fall in the production cost for use of better technology
   A all three
   B (i) and (iii) only
   C (i) and (ii) only
7. Amar restores and sells second hand motorcycles. At 31st December, 2006, he had one motorcycle in inventory. Details of this were :
   Model: Bajaj Boxer
   Details : This item cost ₹ 10,000 and in December, 2006 Amar had also spent ₹ 750 on repairs. He has not yet sold it but is confident to sell it in a motorcycle fair in February 2007 for at least ₹ 15,000. It will cost Amar ₹ 250 to transport motorcycle to the fair.
   The value of motorcycle to be included in the final account for 2006 is
   A ₹ 10,000
   B ₹ 15,000
   C ₹ 10,750
   D ₹ 14,750
8. Amar also holds an inventory of parts, which he values on the periodic weighted average basis. During the year 2006 his purchases of parts was :

Month	Quantity (units)	Cost per unit (₹)
January	400	20
June	500	22
September	300	24

   At 31st September, 2006 he had 300 units in inventory. On 1st January, 2006 he had no parts in inventory. The value of inventory of parts at 31st December, 2006 is
   A ₹ 6,600
   B ₹ 6,000
   C ₹ 7,200
   D ₹ 6,550
9. Following the physical stock taking, the value of total stock is ₹ 1,22,357. The auditors find the following additional information :
   (i) 370 units of stock which cost ₹ 0.40 per unit have been valued @ ₹ 4.00 each.
   (ii) The stock value including damaged goods at their original cost of ₹ 2,885. These goods could be sold for ₹ 3,600 after incurring repairing cost of ₹ 921.
   The correct value of year end stock is :
   A ₹ 1,20,877
   B ₹ 1,20,671
   C ₹ 1,20,819
10. X has closing stock which cost ₹ 38,750. This includes some damaged items which cost ₹ 3,660. It will cost X ₹ 450 to repair these. He will be able to sell them for ₹ 1,500 after the repairs are completed. What is the correct value of X's closing stock ?
   A ₹ 38,750
   B ₹ 36,590
   C ₹ 36,140
11. On 31 March, 2007, inventory code AXN-205 had 1,000 items in inventory. The original cost of this inventory was ₹ 4,600. Alternative valuations were obtained at 31 March, 2007 for this inventory item. Which value should be used in the accounts at 31st March, 2007 as per AS-2 ?
   A original cost ₹ 4,600
   B replacement cost ₹ 3,200
   C net realisable value ₹ 3,400

12. On 31 March, 2007, stock consists of 1,500 units of a raw material purchased @ ₹ 8 each, but the unit price of the item has fallen to ₹ 7. The price reduction is apprehended to be permanent. The firm has already decided that if the price reduction lasts longer than six months it will reduce the sale price of the finished goods from ₹ 12 to ₹ 11. The value of closing stock is :
A ₹ 16,500
B ₹ 10,500
C ₹ 12,000
13. According to AS-2 Inventories, which of the following costs should be included in valuing the inventories of a manufacturing company ?
(i) freight and insurance
(ii) carriage outwards
(iii) depreciation of factory plant
(iv) general administrative overheads
A all four items
B (i), (ii) and (iv) only
C (ii) and (iii) only
D (i) and (iii) only
14. During the year to 31 December, 2006 Amar bought goods for resale at a cost of ₹ 7,55,500. His inventory at 1 January 2006 was valued at ₹ 1,57,400. He did not count his inventory at 31 December, 2006 but he knows that his sales for the year to 31 December, 2006 were ₹ 9,18,000. All sales were made at a mark up of 20%. Based on the information above, what was the value of Amar's inventory at 31 December, 2006 ?
A ₹ 1,36,300
B ₹ 1,47,900
C ₹ 1,66,900
15. Karim is an antiques dealer. His inventory includes a clock which cost ₹ 15,800. Karim expects to spend ₹ 700 on repairing the clock which will mean that he will be able to sell it for ₹ 26,000.
At what value should the clock be included in Karim's inventory ?
A ₹ 15,100
B ₹ 15,800
C ₹ 25,300
16. K Ltd absorbs production overheads into inventory on the basis of units of production. 5,000 identical units were produced during the year ended 31 March, 2008. The normal level of activity is 8,000 units. 800 units remained in inventory at the year end. The production costs incurred in the year were :

	₹
Material costs	12,000
Variable overhead	15,000
Sub-contract labour	8,000
Fixed overhead	24,000

In accordance with As — 2 (Inventory), what should the value of finished goods be stated at in the Balance Sheet of K Ltd. at 31 March, 2008 ?
A ₹ 7,000
B ₹ 7,375
C ₹ 8,000

Guide to Answers

1. B; **2.** C; **3.** A; **4.** C; **5.** B; **6.** C; **7.** C; **8.** D; **9.** C; **10.** C; **11.** C; **12.** C; **13.** D; **14.** B; **15.** B; **16.** C

AS — 3 : Cash Flow Statement (Revised)
[Effective Date : 1st April, 2001]

Introduction

Balance Sheet and Profit and Loss Account prepared by an enterprise (on accrual basis) can not provide the information in respect of its cash flow. An enterprise can earn good profits by selling goods on credit but it may not generate sufficient cash to carry on its operating activities or investing activities. A cash flow statement shows an enterprise's inflows and outflows of cash during a particular accounting period. The statement shows the impact of operating, financing and investing activities on cash.

The ability to make profits may not be enough for the survival of an enterprise. It is also important for the enterprise to generate sufficient cash for its survival. The enterprise must pay great attention to liquidity as well as profitability if they are to succeed.

Negative cash flows for more than one accounting period is a strong sign of potential problem that can affect enterprise's operations as well as financing and investing activities. Therefore, cash flow statement is extremely useful for proper financial planning and control.

Objective

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

Scope

1. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.
2. Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise.

Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Benefits of Cash Flow Information

1. It provides information about an enterprise's liquidity, flexibility and ability to generate future cash flows, which is critically important to survival and to successful growth.
2. It can provide information about an entity's ability to meet its obligations as they become due.
3. It enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments of the same transactions and events.
4. It helps to assess the reliability of the amount of net profit.
5. It can account for the difference between net profit and net cash flow from operating activities.
6. The statement enables users to assess why assets and liabilities are increased or decreased during an accounting period.
7. It can provide information concerning cash and non-cash, financing and investing transactions during an accounting period.
8. It will help in assessing likely future financing needs.
9. It will help in assessing the effect of major events such as issue of shares or acquiring another business on the liquidity of the business.

Definitions

Cash: Cash comprises cash in hand and demand deposits with bank.

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

For example, your company at present holding cash of ₹ 200 crores received from recent IPO. All these cash will be required after two months from now. To earn interest on this cash balance, your company put it in 60 days short-term deposits. This short-term deposit will be treated as cash equivalent.

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

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

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

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

Cash and Cash Equivalents

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

For example, X Ltd. has purchased some preference shares of Reliance Industries Ltd. on 20th January, 2014. These preference shares are due for redemption on 4th April, 2014. These may be considered to be cash equivalents because there is no risk of failure of RIL to pay the amount at maturity.

Here, it should be noted that bank overdraft will be treated as cash and cash equivalents. Bank overdraft is an integral part of an enterprise's cash management.

For example, your company is manufacturing woollen garments only. From September to February, your company is having positive cash balance because of seasonal sale. Your company is putting it in short-term deposit. From March to August the company is having negative cash balance because of purchase of raw materials and other expenses and these are financed by bank overdraft. The overdraft is treated as a cash equivalent.

Cash flows excluded movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

The standard requires that three separate categories of cash flow should be shown in the Cash Flow Statement. These are :

1. Operating Activities;
2. Investing Activities; and
3. Financing Activities.

An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are ***classified differently***.

For example, when the installment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing.

For example, H Ltd. manufactures motor cars. Because of poor response for the new model introduced recently, the operating activity is not generating cash. Inventories are increasing rapidly and dealers are asking excessive credit period. Unless corrective action is taken, H Ltd. will have to take loan from the bank or will have to sell its investments. Therefore, cash flow from operating activities are important.

Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

For example, RIL run chain of super markets — "Reliance Fresh". Every retail store that the company opens require ₹ 50,00,000 of additional inventory. Proper communication of this information will help users to predict the future operating cash flow.

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss.

Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

For example, your company is the owner of few patented life savings drugs. Your company receive an annual licence fee from each manufacturer of the drug, and a royalty for every unit sold. This royalty and licence fee will be treated as cash flows from operating activities.

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) Cash receipts and payments relating to future contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

For example, X Ltd. sold a plant for ₹ 5,00,000. The book value was ₹ 4,00,000. The company made a profit of ₹ 1,00,000. For cash flow purposes, this profit is deducted from net profit and shown in investing activities ₹ 5,00,000 (₹ 4,00,000 + ₹ 1,00,000).

An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Example 1 : Reliance Securities Ltd. is buying and selling securities. Cash flows arising from such activity will be treated as cash flow from operating activities.

Example 2 : HDFC Ltd. is giving housing loans and receiving repayments. The cash flows from these loans are shown as operating activity.

Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of cash flows arising from investing activities are:

(a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

For example, your company T.M. Ltd. has developed a new fuel efficient Bharat III diesel engine for its cars. Total cost for development of the engine is ₹ 150 crores. After successful trial it has been decided by the company to capitalise these expenses. For cash flow purposes, this will be treated as investing activity.

(b) cash receipts from disposal of fixed assets (including intangibles);

(c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

For example, your Company Gujarat Chemicals Ltd. has purchased 15% equity shares of RPL which is supplying raw materials to your company. For cash flow purposes, this purchase of shares will be treated as investing activity.

(d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
(f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Example 1 : Your company, Kamal Printers Ltd. has purchased a printing machine from Germany on credit. This is an investing activity. Your company will have to pay the price in 3 months' time in Euro. Your company has a forward contract to fix the purchase price of the Euro. This will also be treated as investing activity.

Example 2 : Let us assume that Kamal Printers Ltd has purchased ink from Mitsubishi Company, Japan on credit. This is an operating activity. The payment is to be made in two months in Yen. The company has a forward contract to fix the purchase price of the Yen. This is also treated as operating activity.

Financing Activities

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

Reporting Cash Flows from Operating Activities

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.

Illustration 1

From the following summarised Cash Book of Green View Ltd calculate Net Cash Flows from Operating Activities.

Dr. **Summarised Cash Book** **Cr.**

Date	Particulars	₹ '000	Date	Particulars	₹ '000
2014			2014		
April 1	To Balance b/d	50	?	By Payment to Suppliers	2,600
	To Receipts from Customers	3,000	?	By Purchase of Plant	400
	To Issue of Shares	1,000	?	By Wages and Salaries	200
	To Sale of Plant	450	?	By Rent, Rates and Taxes	100
			?	By Income Tax	50
			?	By Dividends	100
			2015	By Repayment of Bank Loan	150
			March 31	By Balance c/d	900
		4,500			4,500

Solution **Green View Ltd.**

Calculation of Net Cash Flows from Operating Activities [Direct Method]

Particulars	₹ ('000)	₹ ('000)
Cash receipts from Customers	3,000	
Cash payments to Suppliers	(2,600)	
Cash paid to Employees (Wages and Salaries)	(200)	
Other Cash Payments (for rent, rates and taxes)	(100)	
Cash Generated from Operations	100	
Income taxes paid (Note 1)	(50)	
Net Cash from Operating Activities		50

Working Note : **(1)** Income tax paid to be shown separately.

Illustration 2

From the following information calculate net cash flows from operating activities :

Dr. **Trading, Profit and Loss Account for the year ended 31st March, 2015** **Cr.**

Particulars	₹	Particulars	₹
To Purchases :		By Sales :	
Cash	6,00,000	Cash	9,00,000
Credit	2,00,000	Credit	1,00,000
To Wages	1,00,000		
To Gross Profit c/d	1,00,000		
	10,00,000		10,00,000
To Depreciation on Plant	20,000	By Gross Profit b/d	1,00,000
To Salaries	50,000	By Interest Received	20,000
To Loss on Sale of Plant	5,000	By Profit on Sale of Long-term Investments	30,000
To Net Profit	75,000		
	1,50,000		1,50,000

All credit sales and purchases were made during the last quarter of the financial year. Therefore, no cash was paid to creditors or collected from debtors during the year.

You are required to calculate Cash Flows from Operating Activities by adopting Direct Method.

Solution **Calculation of Net Cash Flows from Operating Activities [Direct Method]**

Particulars	₹	₹
Cash Sales		9,00,000
Cash Received from Customers		—
		9,00,000
Less: Cash Purchases	6,00,000	
Cash paid to Suppliers	—	
Cash Expenses (Wages + Salaries)	1,50,000	7,50,000
Net Cash Flows from Operating Activities		1,50,000

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 unrealised 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.

Illustration 3

Calculate net cash flows from operating activities from the following :

(i) Profits made during the year ₹ 2,50,000 after considering the following items : —	₹
(a) Depreciation on fixed assets	10,000
(b) Amortisation of goodwill	5,000
(c) Transfer to General Reserve	7,000
(d) Profit on sale of land	3,000

(ii) The following is the position of current assets and current liabilities —

Particulars	2014 (₹)	2014 (₹)
Debtors	15,000	12,000
Creditors	10,000	15,000
Bills Receivable	8,000	10,000
Prepaid Expenses	4,000	6,000

Solution **Calculation of Net Cash Flows From Operating Activities**

Particulars	₹	₹
Profit for the year 2014 after transferring to General Reserve		2,50,000
Add: Transferred to General Reserve		7,000
		2,57,000
Add back :		
Depreciation on fixed assets	10,000	
Amortisation of goodwill	5,000	15,000
		2,72,000
Deduct :		
Profit on sale of land		3,000
Cash Generated from Operations before Working Capital Changes		2,69,000
Increase in debtors	(3,000)	
Decrease in creditors	(5,000)	
Decrease in bills receivable	2,000	
Decrease in prepaid expenses	2,000	(4,000)
Net Cash Flows from Operating Activities		2,65,000

Reporting Cash Flows from Investing and Financing Activities

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows are reported on a net basis.

Reporting Cash Flows on a Net Basis

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and

Examples of cash receipts and payments are:
(a) the acceptance and repayment of demand deposits by a bank;
(b) funds held for customers by an investment enterprise; and
(c) rents collected on behalf of, and paid over to, the owners of properties.

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Examples of cash receipts and payments are advances made for, and the repayments of:
(a) principal amounts relating to credit card customers;
(b) the purchase and sale of investments; and
(c) other short-term borrowings, for example, those which have a maturity period of three months or less.

Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;
(b) the placement of deposits with and withdrawal of deposits from other financial enterprises; and
(c) cash advances and loans made to customers and the repayment of those advances and loans.

Foreign Currency Cash

Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount, the exchange rate between the reporting currency and the foreign currency at the date of the cash flow.

For example, your company Kid's Wear Ltd. has received $ 1,00,000 on March 20, 2015. Company's reporting currency is Rupee. The exchange rate on March 20, was $1 = ₹ 40. The transaction should be reported at ($1,00,000 × ₹ 40) = ₹ 40,00,000.

A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used.

This permits the use of approximate rate in place of actual rate for recording foreign currency transaction.

For example, your company Kid's Wear Ltd. has received $1,00,000 on March 20, 2015. Company's reporting currency is Rupee. The policy of the company is to use Weighted Average Rate. The weighted average rate for the period is 39.95. The rate on March 20 was ₹ 40. The transaction can be reported at ($1,00,000 × ₹ 39,95) = ₹ 39,95,000.

Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates.

Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows.

For example, your Company, Tata Steel Ltd. has a foreign investment worth £250 crores. Company's reporting currency is Rupee. The exchange rate on January 1, 2015 was £1 = ₹ 60, but on 31st March, 2015 it is £1 = ₹ 65. The unrealised gain in rupee is not a cash flow.

However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end of period exchange rates.

For example, your company, REL has a cash balance of 10,000 Euros. Company's reporting currency is Rupee. The exchange rate on 1st April, 2013 was 1 Euro = ₹ 60. The exchange rate on 31st March, 2015 is 1 Euro = ₹ 62. The gain of ₹ 20,000 is an exchange difference and is to be shown separately as part of reconciliation of change in cash and cash equivalents for the period.

Extraordinary Items

The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

For example, your company, Dunlop India Ltd. had a plot of prime land in Kolkata. During the year 2014-15 it has been sold at ₹ 150 crores which is 100 times more than the book value.

This is an extraordinary item and it is to be disclosed separately as cash flowfrom investing activity.

Interest and Dividend

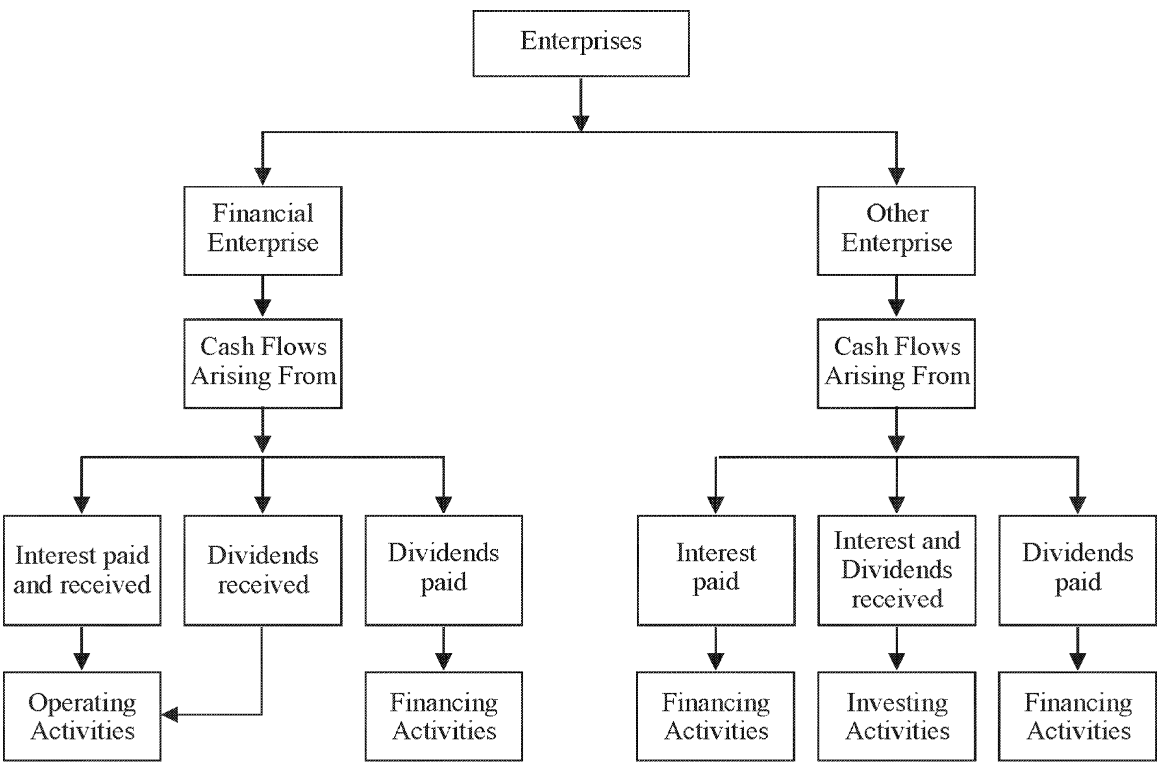
Interest and dividend shall be classified as follows :

For a financial enterprise

Interest paid and received, dividend received as ***operating activities***.
Dividend paid as ***financing activities***.

For other enterprises

Interest and dividend received as ***investing activities***.
Interest and dividend paid as ***financing activities***.
The following diagram will clear the matter.



Interest and dividends are received from investments. Naturally, they should be classified as cash inflows from investment activities (in case of other enterprises).
It should be noted that interest and dividend received from short-term investments included in cash and cash equivalents should be considered as cash inflows from operating activities. Similarly, any interest received on advance to employees, suppliers should be treated as cash inflows from operating activities. Interest paid on long term loan and dividend paid on equity / preference shares should be treated as cash outflows for financing activities. But interest on overdue payment, interest on overdraft etc. should be treated as outflows from operating activities.

Income-tax

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Similarly, income tax refund should be treated as cash inflow from operating activities and to be shown separately.

When tax cash flow are allocated over more than one class of activity, the ***total amount*** of taxes paid is disclosed.

Example 1 : Your company, Dunlop India Ltd. has sold a plot of land in Kolkata for ₹ 150 crores. Capital gain tax of ₹ 30 crores were paid for that transaction. This can be classified as a tax on investing activities.

Example 2 : Your company, X Ltd. has paid ₹ 2,00,000 tax for operating activities, ₹ 3,00,000 for investing activities and ₹ 1,00,000 for financing activities.

In each individual section, tax paid is to be shown separately and total tax paid ₹ 6,00,000 should be disclosed in the cash flow statement as a note.

Investment in Subsidiaries, Associates and Joint Ventures

When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee / joint venture, for example, cash flows relating to dividends and advances.

For example, X Ltd. owns 20% of Y Ltd. X Ltd. provided a loan of ₹ 10,00,000 to Y Ltd. and received ₹ 6,00,000 as dividends. These transactions will appear in the cash flow statement of X Ltd.

The internal cash flows of Y Ltd. are not consolidated into the cash flow figure of X Ltd.

Acquisitions and Disposals of Subsidiaries and Other Business Units

The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as ***investing activities***.

For example, X Ltd. has sold one of its subsidiary for ₹ 40 crores. This proceeds of ₹ 40 crores is to be shown in the cash flow statement of X Ltd. as an investing activity.

An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following :

(a) the total purchase or disposal consideration; and
(b) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line item helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

For example, during 2014-15 H Ltd. buy S Ltd.'s 30% equity shares for ₹ 100 crores. For this purpose, H Ltd. sold one of its subsidiary, X Ltd. for ₹ 80 crores. The flow for purchase of S Ltd. and sale of X Ltd. is to be disclosed in the cash flow statement separately. Net ₹ 20 crores outflow will not be shown in the cash flow statement.

Non-Cash Transactions

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

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are :

(a) the acquisition of assets by assuming directly related liabilities;
(b) the acquisition of an enterprise by means of issue of shares; and
(c) the conversion of debt to equity.

For example, during 2012-13 X Ltd. issued 20,000, 10% fully convertible debentures of ₹ 100 each. These debentures were converted into 2,00,000 equity shares of ₹ 10 fully paid during 2014-15. This conversion of debt into equity involves no inflow or outflow of cash. Therefore, it will not be shown in the cash flow statement of X Ltd. for the year 2014-15.

Components of Cash and Cash Equivalents

An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the Balance Sheet.

For example, cash and cash equivalents includes :
(i) Cash in hand;
(ii) Cash at bank — in current account;
(iii) Short-term bank deposits;
(iv) 5% Government bonds (to be matured within 60 days)

In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) – 5, Net Profit or Loss for the period, prior period items and changes in Accounting Policies.

Other Disclosures

An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it.

Example 1 : G Ltd. has a subsidiary in Bangladesh. It has cash balance of 20 lakhs Taka. The Bangladesh Government has frozen the bank account of the company for violation of foreign exchange regulations. This amount would be disclosed as cash not available for use with proper explanation by the management.
Example 2 : ₹ 20 crores has been deposited by your company in an 'Escrow Account' for the purpose of buy-back of its shares from the market. This amount would be disclosed as cash not available for use.

Additional information may be relevant to users to understand the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include :

(a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these liabilities; and

(b) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

Example 1 : For future requirement, H Ltd. applied for long-term loan. SBI has sanctioned ₹ 100 crores, which can be used in coming 4 years. At present, H Ltd. is using only ₹ 20 crores. This piece of information will help the users to understand the company's future plans for expansion and how it will be financed.

Example 2 : At present, M Ltd.'s Chennai Plant is operating at 100% capacity. During the accounting year 2014-15 the operating activities have generated ₹ 100 crores cash. For the purpose of increasing capacity M Ltd. has purchased 50 acres of land from Tamil Nadu Government which is adjacent to its existing Plant.

A separate disclosure will help the users to understand the future plan of the company.

The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of the operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. A cash flow statement provides information that enables users to evaluate
   A the profitability of the company
   B the solvency of the company
   C the liquidity, flexibility and ability of the company to generate future cash flows.
2. Revenue from sales, expenses paid for purchases, employee salary and overheads comprise
   A operating activities
   B financing activities
   C investing activities
3. Payment to acquire plant and machinery and patents are
   A operating activities
   B investing activities
   C financing activities
4. Cash equivalents are held
   A for investment purposes
   B for the purpose of meeting short-term cash commitments
   C for other purposes
5. Activities that result in changes in the size and composition of the owners' capital and borrowing of the enterprise are
   A investing activities
   B financing activities
   C operating activities

6. An investment normally qualifies as a cash equivalent only when it has a short maturity of, say,
   A six months or less
   B four months or less
   C three months or less
7. Examples of cash flows arising from investing activities are :
   1. Cash received for sale of plant and machinery.
   2. Cash proceeds from issuing of shares.
   3. Cash received from disposal of shares of other enterprise.
   4. Cash paid for buy-back of shares.
   A all four
   B 1, 3 and 4
   C 1 and 3 only
   D 3 and 4 only
8. Examples of cash flows arising from financing activities are :
   1. Cash repayments of amount borrowed on long-term basis.
   2. Cash advances and loans made to third parties by a non- financial enterprise.
   3. Cash proceeds from short-term borrowings.
   A all three
   B 1 and 2 only
   C 1 and 3 only
   D 2 and 3 only
9. Which method of cash flow reporting starts with net profit for calculating cash flow from operating activities ?
   A Direct method
   B Indirect method
   C Neither
   D Both
10. Interest and dividend received from short-term investments included in cash and cash equivalents should be considered as
    A cash flow from investing activities
    B cash flow from financing activities
    C cash flow from operating activities
11. Dividend paid will be treated as cash flow from
    A operating activities in case of a financial enterprise
    B financing activities in case of a financial enterprise only
    C financing activities in case of both financial enterprise and other enterprise
12. Interest on overdue payment and interest on overdraft should be treated as cash flow from
    A financing activities
    B operating activities
    C investing activities
13. Generally cash flows arising from taxes on income should be classified as cash flows from
    A operating activities
    B investing activities
    C financing activities
14. Which of the following statement is true ?
    A The cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented after netting off and classified as investing activities.
    B The cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately as financing activities.
    C The cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately as investing activities.

15. The acquisition of an enterprise by issue of shares will
    A be shown in the cash flow statement under investing activities
    B not be shown in the cash flow statement
    C be shown in the cash flow statement under financing activities
16. Cash flows arising from transactions in a foreign currency should be recorded
    A in an enterprise's reporting currency at the rate on the date of closing the books of account
    B in an enterprise's reporting currency at the rate on the opening date of the accounting period
    C in an enterprise's reporting currency at the rate on the date of cash flow
17. Unrealised gains and losses arising from changes in foreign exchange rates
    A are treated as cash flows from operating activities
    B are not treated as cash flow
    C are treated as cash flows from financing activities
18. Which of the following statement is correct ?
    A cash equivalents are short-term, highly liquid investments that are readily convertible into cash but the amount is not known
    B cash equivalents are short-term, semi-liquid investments that can be converted into cash at a discount
    C cash equivalents are short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value

Guide to Answers

1. C; **2.** A; **3.** B; **4.** B; **5.** B; **6.** C; **7.** C; **8.** C; **9.** B; **10.** C; **11.** C; **12.** B; **13.** A; **14.** C
15. B; **16.** C; **17.** B; **18.** C

AS — 4 : Contingencies and Events Occurring After Balance Sheet Date[1]

[Effective Date : 1 April, 1995]

Introduction

There is a time gap between the Balance Sheet date and the date of approval of accounts by the Board of Directors. Many events may take place between these two dates, which can influence the profits of the enterprise. In many countries these events are reported through notes to the financial statements. However, in India, there is a specific accounting standard AS–4 to deal with post Balance Sheet events.

Events occurring after Balance Sheet date may be favourable or unfavourable.

These events can be disclosed either by changing the amounts included, or by way of disclosure. These measures are considered necessary as a means of ensuring that the financial statements are not misleading.

Definitions

Events after the Balance Sheet Date

Events occurring after the Balance Sheet date are those significant events, both favourable and unfavourable, that occur between the Balance Sheet date and the date on which the financial statements are ***approved by the Board of Directors in the case of a company***, and, by the corresponding approving authority in the case of any other entity.

Here, date of approval of financial statements by the Board of Directors is very important. This date may vary depending on factors such as requirement of the Companies Act, Stock Exchange, etc. The date of approval by the Board of Directors is the end of the post Balance Sheet period.

Example :

(i) On 30.4.2015, A Ltd.'s draft financial statement was ready for the financial year ending on 31st March, 2015.

(ii) On 15.5.2015, the Board of Directors of A Ltd. approved the financial statements for issue.

(iii) On 25.5.2015, the enterprise announced its profits and selected other financial information.

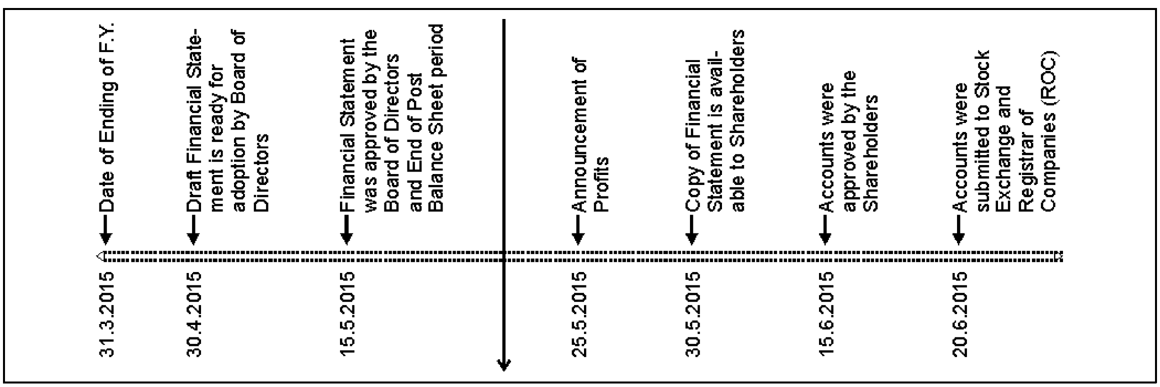
(iv) On 30.5.2015, the financial statements were available with the shareholders of the company.

(v) On 15.6.2015, A Ltd.'s annual general meeting was held and the financial statements of the company was approved by the shareholders.

(vi) On 20.6.2015, the approved financial statements was filed with the Stock Exchange and ROC.

In this case, post Balance Sheet period starts from 1.4.2015 and ending on 15.5.2015.

Date of approval by the shareholders is not vital for this purpose.



[1]In this section, events occurring after Balance Sheet date will be discussed. Matters relating to "**Contingencies in AS–4**" have been superseded by "**AS–29 — Provisions, Contingent Liabilities**".

Events after Balance Sheet Date are classified into ***two*** categories :

(i) Adjusting Events

(ii) Non-adjusting Events

Adjusting Events

Adjusting Events are events that provide additional evidence relating to conditions ***existed*** at the Balance Sheet date and they require changes to be included in the financial statements.

Example 1 : A trade customer, for whose balance, a full specific provision has been made at 31st March, 2015, paid the full amount of ₹ 84,000 before the date of approval of financial statements by the Board of Directors.

It is an adjusting event. Provision for bad debts is to be reduced by ₹ 84,000 in the financial statements.

Journal entry :

Provision for Bad Debts Account	**Dr.**	**₹ 84,000**	
To Profit and Loss Account			**₹ 84,000**

The other examples are :

(a) The valuation of a fixed asset indicating a permanent diminution of value at the Balance Sheet date.

(b) The insolvency of a debtor included in the year and figure for debtors.

(c) The discovery of an error in the accounts.

Example 2 : Swapna Printing Press Ltd. is in the process of repairing one of its printing machine on 31st March, 2015 (the date of closing the books of account). On 10th May, 2015, the servicing company informed that the printing machine is irreparable for non-availability of some vital parts.

The machine at present appearing in the Balance Sheet of 31st March, 2015 at ₹ 40,00,000. The scrap value of the machine is ₹ 5,00,000 only.

Financial statements have not yet been approved by the Board of Directors.

This is an adjusting event. The value of the printing machine should be reduced to ₹ 5,00,000.

Journal Entry

Depreciation Account	**Dr. ₹ 35,00,000**	
To Accumulated Depreciation Account		**₹ 35,00,000**

Non-adjusting Events

Non-adjusting Events concerns conditions that ***did not exist*** at the Balance Sheet date and they do not result in changes in the financial statements, but they may be significant enough to justify a note to the accounts. The financial figures remain unaltered.

Example 1 : In April, 2015 a fire destroyed part of the company's warehouse, with an uninsured loss of inventory worth ₹ 10,00,000 and damaged the building, also uninsured, of ₹ 25,00,000. The going concern status of the company is not affected.

It is a non-adjusting event. The profit of the period under consideration will not be altered. However, a detailed note should be given stating the fact and its impact.

Example 2 : X Ltd. has invested a large amount in shares of Indian Bluechip Companies like Reliance Industries, ONGC and SBI. These shares performed well during the year 2014. Because of different factors, stock market crashed in the month of January, 2015 and remained very depressed until the date of approval of the financial statements. X Ltd. prepares its accounts on calendar year basis.

It is a non-adjusting event and financial figures remain unaltered. However, it is to be disclosed by way of a note stating the amounts involved.

Going Concern

Events occurring after the Balance Sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the Balance Sheet date (e.g., destruction of a major production plant by a fire after the Balance Sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

Example 1 : B Ltd. has prepared its account for year ended 31st March, 2015 in the usual manner. B Ltd.'s only plant has been destroyed by fire on 5th May, 2013. The plant was not insured. Now it is certain that the company will be liquidated.
The financial statements to 31st March, 2015 should be produced on a liquidation basis, not a going concern basis.

Example 2 : R Securities Ltd. has a client, A Agarwal & Co. that owes the company ₹ 50 crores in respect of securities trading on 31st March, 2015.
On 3rd April, 2015, A Agarwal & Co. goes into liquidation. It is estimated that nothing can be recovered from them.
R Securities Ltd. may be able to raise funds to recover the loss but the company is not sure about the timing.
The financial statements to 31st March, 2015 should be produced on a liquidation basis, not a going concern basis because of the uncertainty.

Disclosures

The following information should be disclosed in the report of the approving authority (i.e., Board of Directors) in respect of the events occurring after the Balance Sheet date :

(a) the nature of the event;
(b) an estimate of the financial effect or a statement that such an estimate cannot be made.

Illustration 1

State with reasons, whether the following are adjusting or non- adjusting events :

(a) The professional valuation of a fixed asset one month after the Balance Sheet date at a figure of ₹ 3,00,000 below the current book value. The diminution in value is considered to be permanent.
(b) The destruction of the company's warehouse two weeks after the Balance Sheet date. The loss on the building and the stock it contained amounted to ₹ 6,00,000; due to administrative error neither was insured.

Solution

(a) This is an adjusting event, because the valuation provides information about a condition existing at the Balance Sheet date. If it could be established that the decline in value occurred after the Balance Sheet date, it would become a non-adjusting event.
(b) This is a non-adjusting event which concerns a condition which did not exist at the Balance Sheet date. Moreover this event does not indicate that the enterprise ceases to be a going concern. Therefore, it should be disclosed in the notes to the financial statements.

Illustration 2

An earthquake destroyed a major warehouse of Daya Ltd on 18th May, 2011. The accounting year of the company ended on 31st March, 2011. The accounts were approved on 30th June, 2011. The loss from earthquake is estimated at ₹ 45 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company ?

[C.A. (PCE) — May, 2012]

Solution

The loss due to earthquake is ***not an adjusting event*** because on the Balance Sheet date the earthquake did not exist.

The loss of ₹ 45 lakhs due to earthquake need not be recognised in the financial statement of 2010-11.

As the earthquake loss is significant, it should be mentioned in the Directors' Report of 2010-11. In this report, it is also to be stated that whether going concern assumption is still applicable or not.

Illustration 3

Cashier of A-One Limited embezzled cash amounting to ₹ 6,00,000 during March, 2012. However, the same comes to the notice of the company's management during April, 2012 only. Financial Statements of the company is not yet approved by the Board of Directors of the company. With the help of provisions of AS-4 'Contingencies and Events Occurring after the Balance Sheet Date' decide, whether the embezzlement of cash should be adjusted in the books of account for the year ending March, 2012 ?

What will be your answer, if embezzlement of cash comes to the notice of the company's management only after approval of Financial Statements of the company ?

[C.A. (IPCC) — May, 2012]

Solution

The loss due to embezzlement by the cashier is ***an adjusting event*** because on the Balance Sheet date the embezzlement was existing though it was detected after Balance Sheet date but before approval of financial statements by the Board of Directors. The loss of ₹ 6,00,000 should be recognised in the financial statement of 2011-12.

If the embezzlement of cash comes to the notice of the company's management after the approval of financial statements by the Board of Directors, then it should be treated under AS-5. The loss should be shown in the Statement of Profit and Loss of 2012-13 as ***extraordinary item***. The nature and the amount of prior period items should be disclosed separately in the Statement of Profit and Loss.

Illustration 4

A company entered into an agreement to sell its immovable property to another company for ₹ 35 lakhs. The property was shown in the Balance Sheet at ₹ 7 lakhs. The agreement to sell was concluded on 15th February, 2009 and sale deed was registered on 30th April, 2009. The financial statements for the year 2008-09 were approved by the Board on 12th May, 2009.

You are required to state, how this transaction would be dealt with in the financial statements for the year ended 31st March, 2009.

[C.A. (IPCC) — November, 2009]

Solution

According to para 13 of AS-4 'Contingencies and Events Occurring after the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the Balance Sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the Balance Sheet date. The agreement to sell was concluded on 15th February, 2009, i.e., before the Balance Sheet date. However, the registration of the property was done on 30th April, 2009 and this provides additional information relating to the conditions existing on the Balance Sheet date. Therefore, the assets should be adjusted and the profit on sale of property should be recognised in the financial statements of 2008-09.

Illustration 5

While preparing its final accounts for the year ended 31.3.2013, a company made a provision for bad debts @ 5% of its total debtors. In the last week of February 2013, a debtor for ₹ 2 lakhs had suffered heavy losses due to an earthquake, the loss was not covered by any insurance policy. In April, 2013 the debtor became bankrupt.

Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31.3.2015?

Solution

This is an adjusting event because it provides additional evidence relating to conditions ***existed*** at the Balance Sheet date. The company should provide for the entire amount of ₹ 2 lakhs arising out of bankruptcy of the debtors as loss of the current period.

Illustration 6

A company closed its accounting year on 30.6.2015 and the accounts for that period were considered and approved by the Board of Directors on 20.8.2015. The company was engaged in laying pipeline for an oil company, deep beneath the earth. While doing the boring work on 1.9.2015, it had made a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs.

You are required to state with reasons, how the event would be dealt within the financial statements for the year ended 30.6.2015.

Solution

The date of approval by the Board of Directors is the end of the post Balance Sheet period. Here, accounts were approved by the Board of Directors on 20.5.2015. Any event occurring after this date should be disclosed as a note so as to enable the users of financial statements to make proper evaluations and decisions.

Illustration 7

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.

Solution

The company cannot recognise the unexpected increase in sale price as additional revenue. As per para 8 of AS—4: 'Events Occurring After the Balance Sheet Date', unexpected increase in sale price cannot be regarded as an event occurring after Balance Sheet date, which requires an adjustment of the Balance Sheet date, since it does not represent a condition present at the Balance Sheet date.

This retrospective increase in sale price of petrol 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. This revenue should be recognised in the subsequent year and it should be disclosed properly.

Illustration 8

A company follows April to March as its financial year. The company recognises cheques dated 31st March or before, received from customers after Balance Sheet date, but before approval of financial statement by debiting 'Cheques in Hand Account' and crediting 'Debtors Account'. The cheques in hand is shown in the Balance Sheet as an item of cash and cash equivalents. All cheques in hand are presented to bank in the month of April and are also realised in the same month in normal course after deposit in the bank. State with reasons, whether the collection of cheques bearing date 31st March or before, but received after Balance Sheet date is an adjusting event and how this fact is to be disclosed by the company ?

[C.A. (IPCC) — May, 2010]

Solution

Cheques received after Balance Sheet date bearing the date of 31st March or before is ***not an adjusting event*** because receiving cheques after Balance Sheet date, do not represent any condition existing on the Balance Sheet date.

Collection of cheques after Balance Sheet date does not represent any material change affecting the financial position of the business. Therefore, ***no disclosure in Directors' Report is required***.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Events occurring after balance sheet date are events, favourable or unfavourable, which occur between the Balance Sheet date and the date on which the financial statements:
   A are approved by the shareholders
   B are approved by the accounts committee
   C are approved by the Board of Directors
   D are approved by the audit committee.
2. Which of the following dates marks the end of the period covered by AS–4 ?
   A on 2nd May, 2013 the draft financial statements are ready for issue to accounts committee
   B on 9th May, 2013, accounts committee approves the financial statements
   C on 15th May, 2013 Board of Directors approves the financial statements
   D on 30th May, 2013 shareholders approve the financial statements in the general meeting
3. T.M. Ltd. made a major acquisition after the date of Balance Sheet but before the approval of the financial statements by the Board of Directors. The company should :
   A adjust the financial statements
   B ignore it
   C leave the financial statements but, disclose it by way of a note
4. R Ltd., a pharmaceutical company, has been sued by its competitor for patent violation. For this law suit, the company made a provision of ₹ 10,00,000 in its financial statements at 31st March, 2013 which have not yet been approved.
   On 14th April, 2013 the court awards ₹ 12,00,000 damages against R Ltd. The company should :
   A adjust the financial statements
   B leave the financial statements, but disclose it by way of a note
   C ignore it
5. X Ltd. sold its subsidiary, S Ltd. to Y Ltd. on 1st July, 2012 for ₹ 200 crores. In addition, X Ltd. will get ₹ 10 crores if the subsidiary (S Ltd.) can earn a targeted profit of ₹ 20 crores for the year 2012-13. At the time of preparing financial statements for the period 2012-13, X Ltd. had the information that S Ltd.'s profit for the period was less than targeted profit of ₹ 20 crores. Therefore, sales proceeds of ₹ 200 crores were taken into consideration. Before the approval of financial statements, X Ltd. was informed officially by Y Ltd. that the profits of S Ltd. for the year 2012-13 as per audited accounts is ₹ 21 crores. Now, X Ltd. should :
   A adjust the financial statements for additional ₹ 10 crores sale proceeds (to be received)
   B leave the financial statements but, disclose it by way of a note
   C ignore it now
6. Which of the following events after the balance sheet date would normally qualify as adjusting events according to AS–4 (Events after Balance Sheet date) ?
   1. The insolvency of a customer with a balance outstanding at the balance sheet date.
   2. A decline in the market value of investments.
   3. The declaration of an ordinary dividend.
   4. The determination of the cost of assets purchased before the balance sheet date.

   A 1, 3 and 4
   B 1 and 2 only
   C 2 and 3 only
   D 1 and 4 only
7. Which of the following events occurring after the balance sheet date are classified as adjusting events according to AS–4 (Events after balance sheet date) ?
   1. The sale of inventories valued at cost at a balance sheet date for a figure in excess of cost.
   2. A valuation of land and buildings providing evidence of an impairment in value at the year end.

3. Issue of shares and debentures.
4. The insolvency of a customer with balance outstanding at the end.

A 1 and 3
B 2 and 4
C 2 and 3
D 1 and 4

8. Which of the following material events after the balance sheet date and before the financial statements are approved by the directors should be adjusted for in those financial statements ?
   1. A valuation of property providing evidence of impairment in value at the balance sheet date
   2. Sale of inventory held at the balance sheet date for less than cost.
   3. Discovery of fraud or error affecting the financial statements
   4. The insolvency of a customer with a debt owing at the balance sheet date which is still outstanding.

   A all of them
   B 1, 2 and 4 only
   C 3 and 4 only
   D 1, 2 and 3 only

9. The draft financial statements of X Ltd. are under consideration. The accounting treatment of the following material events after the balance sheet date needs to be determined.
   1. The insolvency of a major customer with a substantial debt outstanding at the balance sheet date.
   2. A fire destroying some of the company's inventory (the company's going concern status is not affected).
   3. An issue of shares to finance expansion.
   4. Sale for less than cost of some inventory held at the balance sheet date.

   According to AS–4 (Events after Balance Sheet date), which of the above events require an adjustment to the figures in the draft financial statements ?

   A 1 and 4 only
   B 1, 2 and 3 only
   C 2 and 3 only
   D 2 and 4 only

10. H Ltd.'s one of the major client has gone into liquidation after the balance sheet date but before the approval of the financial statements by the Board of Directors.
    The amount due was very large and H Ltd. can not survive the loss.
    The financial statements for the year to be produced

    A on a going concern basis
    B on a liquidation basis
    C none of the above

PRACTICAL QUESTIONS

1. While preparing its final accounts for the year ended 31st March, 2015 a company made a provision for bad debts @ 4% of its total debtors (as per trend follows from the previous years). In the first week of March 2015, a debtor for ₹ 3,00,000 had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April 2015 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2015?

[C.A. (IPCC) — Adapted]

Guide to Answers

1. C; **2.** C; **3.** C; **4.** A; **5.** A; **6.** D; **7.** B; **8.** A; **9.** A; **10.** B

AS — 5 : Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
[Effective Date : 1st April, 1996]

Introduction

The Profit and Loss Account for any accounting period should be prepared in such a manner that it is comparable with those of the other years and with the financial statements of other enterprises. This standard is intended to enhance the ***relevance*** and ***reliability*** of the financial statements of the enterprise.

Though the financial information provided by the Profit and Loss Account about the financial performance of an enterprise is historical in nature, yet users use this information to evaluate the enterprise's future performance.

Objective

The objective of this statement is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis.

This statement requires the classification and disclosure of ***extraordinary*** and ***prior period*** items, and disclosure of certain items within profit or loss from ordinary activities.

It also specifies the accounting treatment for changes in ***accounting estimates*** and the disclosures to be made in the financial statements regarding changes in ***accounting policies***.

Scope

1. This Statement should be applied by an enterprise in ***presenting profit or loss*** from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.
2. This Statement deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.
3. This Statement ***does not deal*** with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

Ordinary Activities

Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

Example : X Ltd. is a software development company operating from Kolkata. Recently they have started a training institute for future software developers. All activities relating to training institute will be treated as ordinary activities.

Extraordinary Items

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to re-occur frequently or regularly.

Example : Sale of old machinery and furniture at a profit / loss is an ordinary activity but sale of excess land adjacent to existing factory should be treated as an extraordinary item. Similarly, loss due to earthquake shall be treated as an extraordinary item.

Prior Period Items

Prior period items are income or expenses which arise in the current period as a result of ***errors*** or ***omissions*** in the preparation of the financial statements of one or more prior periods.

Example : Inventory had been overstated in 2014 but it was detected only in 2015. It is a prior period item.

Accounting Policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit or Loss for the Period

All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

a. profit or loss from ordinary activities; and
b. extraordinary items.

Profit or Loss from Ordinary Activities

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 the amount of such items should be disclosed separately. This disclosure will enhance the ***transparency*** in reporting income and expenses.

Example : Sale of old furniture is an ordinary transaction, the profit or loss from such sale should be disclosed separately because it is not related to operation of the business.

A separate disclosure of items of income and expense is necessary in the following cases.

a. the write-down of inventories to net realisable value as well as the reversal of such write-downs;
b. a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;
c. disposals of items of fixed assets;
d. disposals of long-term investments;
e. legislative changes having retrospective application;
f. litigation settlements; and
g. other reversals of provisions.

Illustration 1

During the year 2012-13, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?

[C.A. — Adapted]

Solution

This is an ordinary activity. Ordinary activities are any activities which are usually, frequently or regularly, undertaken by an enterprise as part of its business.

Expenses or income which are exceptional on account of size (large or small) and/or incidence (extent or frequency of occurrence) that arises from the ordinary activities of a business, should be separately disclosed.

Therefore, writing down inventories to net realisable value by ₹ 5,00,000 is ***to be disclosed separately***.

Extraordinary Items

Extraordinary items are those items which arise from abnormal or unusual events lying outside the ordinary range of firm's activities and which are both ***material and expected not to occur frequently or regularly***.

Classification of an item as extraordinary will depend on the circumstances of a business. An event or transaction may be extraordinary for one enterprise but not so for another enterprise. This is because of the differences between their respective ordinary activities. ***For example***, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims for an insurance company that insures against such risks is an ordinary item.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit and 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 such a manner that its impact on current profit or loss will be clearly observed.

It should be remembered that ***only on rare*** occasions do an event or transaction give rise to an extraordinary item.

Illustration 2

A company signed an agreement with the Employees Union on 1.9.2011 for revision of wages with retrospective effect from 30.9.2010. This would cost the company an additional liability of ₹ 5,00,000 p.a.

Is a disclosure necessary for the amount paid in 2011-12?

[C.A. — Adapted]

Solution

The additional wages liability of ₹ 7,50,000 (₹ 5,00,000 p.a. for $1^1/_2$ years) should be included in current year's wages, as it arises from ordinary activities of the organisation. This should not be treated as a prior period item since it does not arise because of an error in an earlier accounting year has been discovered. Likewise, the nature of additional expense is not such that it can be treated as an extraordinary item, which arises only on ***rare occasion***.

Ordinary activities which are exceptional on account of size (large or small) and/or incidence (extent of frequency or incidence) should be separately disclosed. Therefore, in this case, ***disclosure*** is necessary for the additional wage payment to be made.

Illustration 3

X Co. Ltd. signed an agreement with its employees union for revision of wages in June 2004. The wage revision is with retrospective effect from 1.4.2000. The arrear wages up to 31.3.2004 amounts to ₹ 80 lakhs. Arrear wages for the period from 1.4.2004 to 30.6.2004 (being the date of agreement) amounts to ₹ 7 lakhs.

Decide whether a separate disclosure of arrear wages is required.

[C.A. (PE - II) — November, 2005]

Solution

Revision of wages was made in June 2004 with retrospective effect from 1.4.2000. The additional wages liability ₹ 87 lakhs (₹ 80 lakhs + ₹ 7 lakhs) should not be treated as a prior period item since it does not arise because of an error or omission in an earlier accounting year which has been discovered now. Likewise, the nature of additional wages is not such that it can be treated as an extraordinary item, which arises only on rare occasion. This additional wages of ₹ 87 lakhs should be shown in the Profit and Loss Account for the year ended 31st March, 2005.

Para 12 of AS—5 (Revised) states that when items of income and expense within profit and 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.

Therefore, ₹ 80 lakhs wages (for the period 1.4.2000 to 31.3.2004) should be ***disclosed separately***. However, wages payable for the current year (1.4.2004 to 30.6.2004) ₹ 7 lakhs need not be shown separately. It will be merged with the wages of the current year, i.e., 2004-05.

Prior Period Items

The term 'Prior Period Items' refers only to income and expenses which occurred in a previous period. It will normally arise because some errors in an earlier account has been discovered. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. Material errors in the Profit and Loss Account of one accounting period that are discovered in a subsequent period usually involve an asset or liability and a revenue or expense of a period. They do not include normal recurring adjustments (e.g., arrears payable to workers in current period as a result of retrospective revision of wages) or correction of accounting estimates made in prior years.

Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profits or losses.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

Illustration 4

In preparing the financial statements of R Limited for the year ended 31.3.2016, you come across the following information. State with reasons, how you would deal with them in the financial statements:

There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only during the current financial year.

[C.A. — Adapted]

Solution

This is a prior period item. It is an error as a result of oversight. This error was discovered in the subsequent period. Since this loss was not charged in the previous year, there was an overstatement of profit, brought forward to the current year. Therefore, adjustments are to be made in the opening stock of the current year and the profit brought forward from the previous year. The amount of loss should be shown in the Profit and Loss Account after determination of current net profit or loss.

Illustration 5

Goods worth ₹ 5,00,000 were destroyed due to flood in September, 2014. A claim was lodged with insurance company. But no entry was passed in the books for insurance claim in the financial year 2014-15.

In March 2016, the claim was passed and the company received a payment of ₹ 3,50,000 against the claim. Explain the treatment of such receipt in final accounts for the year ended 31st March, 2016.

[C.A. (IPCC) — Adapted]

Solution

This is a prior period item. This is an error occurred in 2014-15 due to negligence. In March 2016, claim of ₹ 3,50,000 was received and it should be separately disclosed in the Statement of Profit and Loss for the year ending on 31st March, 2016.

Illustration 6

During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company's 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.

[C.A. — Adapted]

Solution

Company's proposed accounting treatment of writing back off the 'maintenance provision' as a prior period item is ***not correct***.

As per definition given in AS——5: "Net Profit or Loss for the Period, Prior Period Items and Change in Accounting Policies", prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of prior periods. However, the company should disclose it as an extraordinary item if the amount is material.

Change in Accounting Estimates

The use of reasonable estimates is an essential part of the preparation of financial statements. The process of accounting requires estimation in many areas, ***for example***, allowance for doubtful debts, inventory obsolescence or estimated useful lives of fixed assets.

Estimation involves judgments based on the latest available information. Accounting estimates, by their very nature, can rarely be measured with precision. Where circumstances change or new information becomes available the accounting estimate may need to be revised. ***The revision of an estimate does not relate to prior periods and is not the correction of an error***.

The effect of a change in an accounting estimate should be included in the determination of net profits and losses in :

(a) the period of the change, if the change affects that period only (e.g., provision for doubtful debts);

(b) the period of change and future periods, if the change affects both (e.g., change in the estimated life of a fixed asset).

Example : Your company Delhi Transport (P) Ltd. has a fleet of 20 diesel buses which are operating in NCR (National Capital Region) area. New legislation on pollution will ban them for use in NCR from 1st April, 2013, reducing their useful lives. The company will need to accelerate depreciation and review their residual values. This is a revision in estimates and will have no effect on prior periods, but the depreciation of the current year and subsequent years will increase.

Illustration 7

While preparing its final accounts for the year ended 31.3.2012, Rainbow Limited created a provision for bad and doubtful debts at 2% on trade debtors. A few weeks later, the company found that the payments from some of the major debtors were not forthcoming. Consequently, the company decided to increase the provision to 10% on the debtors as on 31.3.2012 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extraordinary item or prior period item?

[C.A. — Adapted]

Solution

This is a change in accounting estimate. It is not to be considered as an extraordinary item or prior period item.

The provision for bad and doubtful debts has been increased from 2% to 10%. The effect of change should be shown in the Profit and Loss Account for the year ending on 31st March, 2012.

Illustration 8

A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2003-04.

Subsequently, on a review of the credit period allowed and financial capacity of the customers, the company decides to increase the provision to 8% on debtors as on 31.3.2004. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard, can this revision be considered as an extraordinary item or prior period item ? ***[C.A. (PE - II) — Nov., 2004]***

Solution

This is a change in accounting estimate. It is not to be considered as an extraordinary item or prior period item.

The provision for bad and doubtful debts has been increased from 2.5% to 8%. The effect of change should be shown in the Profit and Loss Account for the year ending on 31st March, 2004.

Disclosure

Change in estimates are disclosed, except when it is impracticable to estimate the impact and the reasons for non-disclosure should be disclosed.

Changes in Accounting Policies

Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

Example : Sita Travels Ltd. is a tour operator, operating 50 luxury buses at present. The company is charging depreciation under Straight Line Method for all buses (AC and non-AC). During the accounting period 2014-15 the company has acquired 10 Volvo buses. It can be assumed that the company will depreciate these new buses under Straight Line Method also.

A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Example : H Ltd.'s inventory has been accounted for using Last-In-First-Out (LIFO) method. AS—2 (Inventories) does not allow LIFO for valuation of inventory. The company has changed its policy to FIFO in accordance with AS—2.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

Students should note that the following are not changes in accounting policies :

a. the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions.

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

b. the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Example : X Ltd. is using financial instruments for the first time and apply AS—30. This is not a change in accounting policy.

Disclosure of Change in Accounting Policies

(a) Any change in an accounting policy should be disclosed if it has a material effect.

(b) The impact of change should be shown in the financial statements of the period in which such change is made.

(c) Where the effect of such change is not ascertainable, the fact should be indicated.

(d) If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Example : X Ltd. at present showing buildings at cost in its books of account. At the end of the financial year 2014-15, the company has decided to revalue the buildings (because the price of properties have increased three times in that locality).
The revaluation profit will increase charge for depreciation on buildings in the current and future periods. This change in policy should be appropriately disclosed in the year 2014-15.

A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard.

***Students should note that in many cases it could be difficult to distinguish between a change in accounting policy and a change in an accounting estimate. In such a situation, the change is treated as a change in an accounting estimate*.**

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Profit on sale of old furniture :
   A is an ordinary activity
   B is an extraordinary activity
   C is a prior period item
2. Extraordinary items
   A are both material and expected to occur frequently or regularly
   B are not material and expected not to occur frequently or regularly
   C are both material and expected not to occur frequently or regularly
3. Errors include :
   1. Mathematical mistakes
   2. Mistakes in applying accounting policies
   3. Changes in provisions for bad and doubtful debts
   4. Misinterpretation of facts, or oversight.
   Which of the following is correct ?
   A all four
   B all except 4
   C all except 3
4. Revision of salary with retrospective effect is a
   A change in policy
   B change in accounting estimate
   C prior period item
5. Change in accounting policies
   A should only make the change in the coming period
   B should only make the change in the current period
   C should make the change in the periods reported
6. Change in the method of depreciation will be treated as
   A change in the accounting policy
   B change in the accounting estimate
   C none of the above
7. Revision of estimated useful life of a fixed asset
   A is a change in accounting policy
   B is a change in an accounting estimate
   C none of the above
8. The effect of a change in an accounting estimate should be included in the determination of net profits or losses of the
   A current period only
   B previous periods only
   C current period as well as future periods
9. Accounting estimates are made for
   1. Change in accounting policy
   2. Provision for bad and doubtful debts
   3. Inventory obsolescence
   A all three above
   B all except 1
   C all except 2

PRACTICAL QUESTIONS

1. A company signed an agreement with the employees' union on 01.09.2010 for revision of wages with retrospective effect from 01.04.2009. This would cost the company an additional liability of ₹ 10 lakhs per annum. Is a disclosure necessary for the amount in paid in 2010-11 ? ***[C.A. (IPCC) — May, 2011]***
2. A company created a provision of ₹ 75,000 for staff welfare while preparing the financial statements for the year 2011-12. On 31st March, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welffare to ₹ 1,00,000. The accounts were approved by Board of Directors on 15th April, 2012.
   Explain the treatment of such revision in financial statements for the year ended 31st March, 2012.
   [C.A. (IPCC) — Adapted]

Guide to Answers

1. A; **2.** C; **3.** C; **4.** B; **5.** C; **6.** A; **7.** B; **8.** C; **9.** B

AS — 6 : Depreciation Accounting (Revised)
[Effective Date : 1st April, 1995]

Introduction

Different fixed assets, for example, buildings, machinery and furnitures are used by an enterprise for different purposes like production, administration, sales and service, etc. Expenditure is made early in the life of the assets for acquiring the assets but benefits are derived throughout their useful life.

When a fixed asset is acquired, it is recorded in the books of account at its acquisition cost and it is capitalised. In each accounting period, a portion of acquisition cost is charged to the Profit and Loss Account as expense. This accounting process of gradually converting the acquisition cost of fixed asset into expense over a series of accounting periods is called ***depreciation***.

Objectives

Depreciation has a significant effect in the preparation of the financial statements of an enterprise. It will influence the profit / loss and value of assets of the enterprise. Different enterprises adopt different accounting policies for depreciation.

The main objective of this accounting standard is to prescribe the ***guidelines for charging depreciation*** for different assets.

Scope

This statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply —

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

This statement also does not apply to land unless it has a limited useful life for the enterprise.

Definitions

Depreciation

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

Depreciable Assets

Depreciable assets are assets which

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

Useful Life

Useful life is either :

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

Depreciable Amount

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

Factors in the Measurement of Depreciation

The amount of depreciation to be charged for a particular fixed asset will depend upon the following three factors :

(i) Cost of the asset
(ii) Useful life of the asset
(iii) Residual value of the asset

Cost of the Asset

The cost of an asset is the basis for calculation of depreciation. For the purpose of determination of cost of an asset, the following points are important as stated in AS—10 "Accounting for Fixed Assets" :

(a) Where an asset is purchased from a supplier: The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.

Examples of directly attributable costs are :

(i) site preparation;
(ii) initial delivery and handling costs;
(iii) installation cost, such as special foundations for plant; and
(iv) professional fees, for example, fees of architects and engineers.

(b) Where an asset is self-constructed : The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

(c) Where a fixed asset is acquired either in exchange or in part exchange for another asset: The asset acquired should be recorded either :

(i) at its fair value; or
(ii) the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration.

Useful Life of the Asset

The useful life of an asset is its ***service life*** which can be defined as the number of accounting periods during which it will be useful to the business. The physical life of an asset may be considered longer than its economic life. When the operating cost of an asset is considered to be more than the revenue which it generates, it has exceeded its economic life and should not be kept in use. Since there is no way to measure correctly how long an asset will be useful, the asset's useful economic life is always estimated.

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

(i) expected physical wear and tear;
(ii) obsolescence;
(iii) legal or other limits on the use of the asset, e.g., safety limitation or the expiry dates of assets taken on lease.

Estimation of useful life of the asset is very difficult. It is a matter of judgment and depending on the experience of the enterprise with similar assets. Depreciation will vary directly with the useful life of the asset. If the estimated life is too long, each year's depreciation charge will be less and profits in the periods before disposal will be inflated.

Residual Value of the Asset

Residual value of asset is the estimated value of a fixed asset at the end of its economic life. It is the amount which is expected to be received when the asset is sold after being removed from service. The purpose of estimating residual value is to ascertain the ***depreciable amount*** (acquisition cost – residual value), which is allocated to different accounting periods during which the asset is gainfully employed. Depreciable amount is calculated as under:

Acquisition cost (say)	₹ 11,00,000
Less : Residual Value (say)	₹ 1,00,000
Depreciable Amount	₹ 10,00,000

Example : It is the policy of Sita Travel (P) Ltd. to keep their tourist bus in service for 5 years only. The company has purchased one new tourist bus for ₹ 25,00,000. A similar bus purchased 5 years back can be sold at present for ₹ 5,00,000 (Net). Here ₹ 5,00,000 is a reasonable estimate for the residual value of the new bus.
The depreciable amount will be ₹ 20,00,000 (₹ 25,00,000 – 5,00,000).
Annual depreciation = ₹ 20,00,000 / 5 = ₹ 4,00,000.

Unless the residual value of the asset is guaranteed (e.g., buyback by the manufacturer at a guaranteed amount), the residual value will only be ***estimate*** because of future uncertainties.

In some cases, residual value is insignificant and it is taken as zero for calculating the amount of depreciation.

The higher the residual value, the lower will be the depreciation charge. In effect, the profits of the previous periods will be inflated and there may be a loss on disposal of the asset.

Depreciation Methods

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the ***straight line*** method and the ***reducing balance*** method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

No particular method is specified by AS—6. However, it has been stated in para 20 that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

Example : If a machine costs ₹ 1,20,000 on 1.1.2008, has a residual value at ₹ 20,000 and a life of 10 years, assuming the accounting year ends on 31st December, the depreciation per annum will be :

$$Depreciation = \frac{1{,}20{,}000 - 20{,}000}{10} = ₹\ 10{,}000.$$

1. Straight Line Method

This is the most popular method because of its simplicity and consistency. It requires allocation of an equal amount to each period. The asset is written down in value each year by the same amount. Since this method assumes that the cost of the asset expires at a steady (straight line) function of time, the acquisition cost less residual value is divided by the estimated economic life.

$$Annual\ Depreciation = \frac{Cost\ of\ the\ Asset - Residual\ Value}{Estimated\ Economic\ Life}$$

2. Reducing Balance Method

Under this method, a fixed rate on the reduced balance of the asset is charged as depreciation every year. Though the percentage at which depreciation is charged remains fixed, the amount of depreciation goes on diminishing.

Example : On 1st January, 2014, X Ltd. purchased a motor car for ₹ 5,00,000. It is the policy of the company to charge depreciation @ 20% p.a. on reducing balance method.

The depreciation will be as follows :

2014 — 20% of ₹ 5,00,000	**₹ 1,00,000**
2015 — 20% of ₹ (5,00,000 – 1,00,000)	**80,000**
2016 — 20% of ₹ (5,00,000 – 1,80,000)	**64,000**
2017 — 20% of ₹ (5,00,000 – 2,44,000)	**51,200**

3. Machine Hour Rate Method / Unit of Production Method

This method of depreciation is suitable for those assets whose life mainly depends upon the usage of the assets. Depreciation is calculated as :

(1) $\text{Depreciation per hour} = \dfrac{\text{Cost of the Asset} - \text{Residual Value}}{\text{Effective Working Hours}}$

(2) $\text{Depreciation per unit} = \dfrac{\text{Cost of the Asset} - \text{Residual Value}}{\text{Total Estimated Number of Units}}$

Example 1 : 'Dell Laptop - EXP' is estimated to have effective life of 20,000 hours. The cost of the laptop is ₹ 60,000 with no residual value. If the laptop has worked for 2,000 hours in 2014 and 3,000 hours in 2015, then the depreciation will be as follows :

$$\textbf{Depreciation per hour} = \frac{\text{Cost of the Laptop} - \text{Residual Value}}{\text{Estimated Effective Working Hours}}$$

$$= \frac{60{,}000}{20{,}000} = \textbf{₹ 3}$$

Depreciation for 2014 = 2000 × ₹ 3 = ₹ 6,000

2015 = 3,000 × ₹ 3 = ₹ 9,000.

Example 2 : Apollo Hospital has purchased a new 'X-Ray' machine for ₹ 5,00,000. It is estimated that 10,000 X-ray plates can be exposed throughout its economic life. The residual value is expected to be ₹ 50,000.

$$\textbf{Depreciation per X-Ray plate} = \frac{5{,}00{,}000 - 50{,}000}{10{,}000} = \textbf{₹ 45}$$

Change in the Method of Depreciation

The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

The following points are important :

1. ***The change in the method of depreciation should be treated as a change in accounting policy. Accordingly, depreciation should be recomputed in accordance with the new method from the date of first use of the asset.***
2. ***The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed.***
3. ***The deficiency or surplus of depreciation in respect of past years, should be debited or credited to the Profit and Loss Account of the year of change in the method of depreciation.***

Illustration 1

X Co. Ltd. charged depreciation on its assets on SLM basis. For the year ended 31.3.2015, it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to ₹ 20 lakhs being additional charge.

Decide how it must be disclosed in Profit and Loss Account. Also discuss, when such change in method of depreciation can be adopted by an enterprise as per AS—6.

Solution

Para 21 of AS—6 states that in case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged to the Statement of Profit and Loss.

Here, ₹ 20 lakhs should be charged to the Profit and Loss Account for the year ended on 31st March, 2015.

An enterprise may change the method of depreciation only under the following conditions :

(a) the change is required by a statute or an Accounting Standard;

(b) the change would produce a more appropriate presentation.

Illustration 2

Ram Co. (P) Ltd. furnishes you the following information for the year ended 31.3.2015 :

		(₹ in lakhs)
(i)	Depreciation for the year ended 31.3.2015 (under SLM)	100
(ii)	Depreciation for the year ended 31.3.2015 (under WDV)	200
(iii)	Excess of depreciation for the earlier years calculated under WDV over SLM	500

The company wants to change its method of charging depreciation from straight line method to written down value method.

Decide how the depreciation should be disclosed in the financial statement for the year ended 31.3.2015.

Solution

Para 21 of AS—6 states that

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

In this case, the deficiency of ₹ 500 lakhs would be charged to the Profit and Loss Account for the year ending on 31st March, 2015.

In the notes to account the reasons for change in the method of depreciation is to be elaborated. The effect of ₹ 500 lakhs is also to be disclosed. Current year's depreciation of ₹ 200 lakhs is to be charged to Profit and Loss Account for the year ended 31st March, 2015.

Illustration 3

A plant was depreciated under two different methods as under :

Year	SLM (₹ in Lakhs)	WDV (₹ in Lakhs)
1	7.80	21.38
2	7.80	15.80
3	7.80	11.68
4	7.80	8.64
	31.20	57.50
5	7.80	6.38

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

Solution

Here, in this case, there is a surplus of ₹ 26.30 lakhs (57.50 – 31.20) on account of change in the method of depreciation.

As per para 21 of AS—6, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The surplus arising from retrospective recomputation of depreciation in accordance with the new method should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Therefore, the surplus of ₹ 26.30 lakhs will be ***credited*** to Profit and Loss Account.

Revision of the Estimated Useful Life

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

Illustration 4

On 1.4.2012, ABC Limited purchased plant and machinery worth ₹ 20,00,000, useful life being 8 years. Till the year ended 31.3.2015, the amount of accumulated depreciation on this plant and machinery was ₹ 8,00,000. The remaining useful life of the plant and machinery was reviewed during 2015-16, which was estimated at 2 years due to wear and tear. Calculate the amount of depreciation to be charged from the year 2015-16 onwards.

Solution

Here, in this case, the unamortised depreciable amount is ₹ (20,00,000 – 8,00,000) = ₹ 12,00,000 and the revised remaining useful life is 2 years. Therefore, the amount of depreciation to be charged from the year 2015-16 onwards is ₹ 12,00,000 / 2 = ₹ 6,00,000 p.a.

Depreciation on Addition or Extention of the Asset

Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset.

Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.

Example : ACC Ltd. has installed a conveyor belt system for material handling at its 25 years old cement plant. The cost of the entire conveyor belt unit is ₹ 20,00,000 and its useful life is 10 years without any residual value. However, the remaining life of the principal plant is 5 years.
The conveyor belt unit should be recognised as an item of fixed asset separate from principal plant. It will be depreciated over its useful life, i.e., 10 years. However, if the 'conveyor belt' cannot be used separately, its useful life will terminate with the life of the principal plant, i.e., 5 years. The entire amount of ₹ 20,00,000 is to be depreciated in 5 years.

Illustration 5

On 1.4.2013, the value of X Limited's plant and machinery was ₹ 1,000 lakhs. The company provided depreciation @ 15% p.a. under Reducing Balance Method. It was found that about ₹ 150 lakhs of imported asset, which is the component of plant and machinery acquired on 1.4.2013, would be obsolete in 3 years. Accordingly, X Limited wants to write off this asset over 3 years. Can the company do so as per AS–6?

Solution

As per para 24 of AS–6, any addition or extention which becomes an integral part of the existing asset should be depreciated **over the remaining useful life of that asset**. The depreciation on such addition or extention may also be provided at the rate applied to the existing asset. Where an addition or extention retains a separate identity and is **capable of being used after the existing asset is disposed of**, depreciation should be provided **independently** on the basis of an estimate of its own useful life.

Therefore, in this case, the company can write off the asset in 3 years, since the asset has independent useful life.

Change in the Historical Cost

Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided ***prospectively*** over the residual useful life of the asset.

Illustration 6

ABC Ltd. purchased an imported Printing Machinery from Germany for ₹ 20,00,000 on 1.4.2009. The life of the machine is 10 years without any residual value. The company followed straight line method of depreciation. During 2013-14 due to change in foreign exchange rate the amount of unpaid liability increased by ₹ 3,00,000.

Calculate amount of depreciation to be charged for the year 2013-14 and onwards.

Solution

		₹
Cost of the printing machinery		20,00,000
Less: Depreciation under SLM :		
2009-10	2,00,000	
2010-11	2,00,000	
2011-12	2,00,000	
2012-13	2,00,000	8,00,000
Unamortised depreciable amount on 1.4.2013		12,00,000
Add: Increase in liability for change in foreign exchange		3,00,000
Revised depreciable amount		15,00,000

Depreciation for the year 2013-14 and onwards :

$$\text{Depreciation p.a. - } \frac{15{,}00{,}000}{(10 - 4)} = ₹\ 2{,}50{,}000$$

Depreciation of Revalued Assets

Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

Illustration 7

A Ltd acquired a building on 1st January, 1997 at a cost of ₹ 6,40,000. The useful life of the building was estimated as 50 years and depreciation is provided on a straight line basis. The building was revalued on 30th June 2014 for ₹ 16,80,000 and the revaluation incorporated in the accounts. Assuming no change made to the remaining useful life. You are required to calculate : (i) the surplus on revaluation; (ii) depreciation to be charged in the Profit and Loss Account of 2014.

Solution

(i) Surplus on Revaluation

	₹
Revaluation at 30th June, 2014	16,80,000
Net book value at 30th June, 2014 (Note 1)	4,16,000
Surplus	12,64,000

This surplus of ₹ 12,64,000 should be credited directly to owners' interests under the heading of Revaluation Reserve as per the requirement of AS—10 Para 30.

(ii) Depreciation Charged in the Profit and Loss Account of 2014

Here, it should be noted that upto 30.6.2014 depreciation will be calculated on original value and from 1.7.2014 it is to be calculated on revalued value.

	₹
(a) On historical cost (upto 30.6.2014) — $\frac{6,40,000}{50} \times \frac{1}{2}$	6,400
(b) On revalued amount (1.7.2014 to 31.12.2014) — $\frac{16,80,000}{32\frac{1}{2}} \times \frac{1}{2}$	25,846
Total	32,246

Working Note :

(1) Net Book Value on 30th June, 2014

	₹
Original cost on 1.1.1997	6,40,000
Less: Depreciation for 17.5 years (₹ 6,40,000 / 50 × 17.5)	2,24,000
	4,16,000

Disclosure

1. If any depreciable asset is disposed of, discarded or destroyed, the net surplus or deficiency, if material, should be disclosed separately.
2. The following information should be disclosed in the financial statements:
   (i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;
   (ii) total depreciation for the period for each class of assets; and
   (iii) the related accumulated depreciation.
3. The following information should also be disclosed in the financial statements alongwith the disclosure of other accounting policies:
   (i) depreciation methods used; and
   (ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

OBJECTIVE TYPE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. AS—6 deals with depreciation accounting and applies to all depreciable assets, except :
   A assets used for administrative purposes
   B assets used for sales and service
   C wasting assets
2. Depreciable assets are assets which
   A have unlimited useful life, e.g., land
   B have a limited useful life, e.g., furniture
   C are expected to be used not for more than one year
3. Residual value is specifically
   A scrap value
   B the estimated value of a fixed asset at the end of its economic life
   C the estimated value of a fixed asset at the end of its physical life

4. The useful life of an asset is :
   A its service life
   B its physical life
   C none of the above
5. Which of the following statement is **not** correct ?
   A depreciation will vary directly with the useful life of the asset
   B the higher the residual value, the lower will be the depreciation charge
   C the higher the residual value, the higher will be the depreciation
6. Repairs and maintenance costs are :
   A normally capitalised
   B expensed in the profit and loss account as incurred
   C recorded as deferred expenses
7. Which of the following statement is correct in relation to AS—6 ?
   A only straight line method can be adopted for calculation of depreciation
   B only reducing balance method can be adopted for calculation of depreciation
   C no particular method has been specified for calculation of depreciation
8. Which of the following statement is correct in relation to AS—6 ?
   A the change in the method of depreciation should be treated as a change in estimate
   B the change in the method to depreciation should be treated as change in accounting policy but the depreciation should be computed in accordance with the new method from the date of change in the method of depreciation
   C the change in the method of depreciation should be treated as change in accounting policy but the depreciation should be recomputed in accordance with the new method from the date of first use of the asset
9. The cost of a fixed asset should comprise :
   (i) its purchase price
   (ii) any attributable cost of bringing the asset to its working condition for intended use
   (iii) overhead of purchase department relating to the purchase of asset
   Which of the following is correct ?
   A (i) only
   B (i) and (ii) only
   C (i), (ii) and (iii)
10. Depreciation charges for a period are recorded
    A only in the Profit and Loss Account
    B only in the Balance Sheet
    C in the Profit and Loss Account or as part of the Cost of another asset (such as inventory).

Guide to Answers

1. C; **2.** B; **3.** B; **4.** A; **5.** C; **6.** B; **7.** C; **8.** C; **9.** B; **10.** C.

AS — 7 : Accounting for Construction Contracts (Revised)
[Effective Date : 1st April, 2003]

Introduction

AS—7 deals with accounting for construction contract in the financial statements of the contractor. It also applies to enterprises undertaking construction activities on their own account (not as contractors) as a venture of a commercial nature where the enterprises have entered into agreement for sale.

In many cases, contracts can span for more than one accounting year and this creates some dilemma.

The question which arises are :

(i) how much revenue should be included in the Profit and Loss Account ?
(ii) how much should be charged for related costs ?
(iii) how much profit should be recognised in the current period in respect of a particular contract ?

AS—7 prescribe the accounting treatment for the above matters.

Meaning of Some Important Terms

Fixed Price Contract

In this type of contract, price is usually fixed and agreed upon in advance. Generally, tenders are invited, giving details of the contract, to fix up the contract price. As per agreement between the parties, any additional work may be charged separately. There may be a provision in the agreement to allow the contractor to pass to the contractee additional costs incurred due to price rise of materials or wages, awards, etc.

Cost Plus Contract

Cost plus contract is a contract in which price is not agreed upon in advance for one reason or other. This type of contract is entered into when it is impossible to calculate future price or cost with reasonable accuracy because of lack of past records and experience or because of particular circumstances, for example, digging of an oil well. The contract price is ascertained later by adding a fixed percentage of profit to the total cost of the contract. The different items of expenditure to be considered for ascertaining cost of the contract are agreed upon in advance.

Scope

Construction contracts include :

(i) Services related to the construction, such as project managers and architects.
(ii) Contracts for destruction, or restoration, of assets and the restoration of the environment.

Example 1 : L&T Ltd. has received a contract for the construction of a bridge over Hooghly river near Kolkata. For the construction of the new bridge, the old existing bridge is to be demolished. This demolition is a part of the bridge contract.

Example 2 : Your company HRBC Ltd. is constructing a new 6 lane highway on behalf of Highway Authority of India. A clause in the contract requires that on both the sides of the highway, three rows of trees are to be planted at the cost of the company. This is a part of the highway contract.

Combining and Segmenting Construction Contracts

When a contract covers more than a single asset, the construction of each asset should be treated as a separate contract when :

(i) separate proposals have been submitted for each asset;
(ii) separate negotiation for each asset and each party has the right to reject the part of the contract
(iii) costs and revenue of each asset can be measured.

Example : Jindal Steel Co. Ltd. is putting a new steel plant in West Bengal. L&T Ltd., the contractor has submitted three separate bids for the following :

(a) Blast Furnace ₹ 600 crore
(b) Captive Power Plant ₹ 100 crore
(c) Conveyor Belt ₹ 20 crore.

Each one of the above should be treated as a separate contract.

A group of contracts, with one client or more, should be treated as a single contract when :

(i) the contracts were signed as a single package;
(ii) the contracts are in essence part of a single project with the overall profit margin.
(iii) the contracts are executed concurrently or in a continuous sequence.

For example : Simplex Ltd. has received a contract from West Bengal Industrial Development Corporation Ltd. for the design, development and construction of a IT Park in Siliguri, West Bengal. Contract includes the construction of :

(a) Buildings for IT companies;
(b) Common Conference Hall;
(c) Food Court;
(d) Swimming Pool;
(e) Gymnasium, etc.

All the contracts are covered under a master contract. For accounting purposes, Simplex Ltd. should treat all contracts as a single contract.

Contract Revenue

Contract revenue should comprise the following :

(i) The amount of revenue agreed by the contractee initially.
(ii) Variation in contract work, claims and incentive payments.
(These are included in the revenue if there is a chance that they will result in revenue and are capable of being reliably measured).

For various reasons, such as cost escalation clauses, claims, penalties, etc., contract revenue could be increased or decreased from one period to next.

Variation in Contract Work

Contract variation may change the scope of the contract and in return the revenue of the contract will also be changed.

For example : Your company Modern Road Construction Company Ltd. has received a contract for converting a two lane road into four lane road through the city. Public is protesting for demolition of unauthorised construction of two sides of the present road. It is becoming a political issue. Now the Municipal Corporation has decided that a flyover will be constructed to solve the problem. The contract would be revised accordingly along with the revenue.

Claims

In some cases, contractor claims extra money from the client for cost not included in the original contract. It might so happen because of some unforeseen events which is beyond the control of the client.

For example : HCC Ltd. has received a contract from Tata Motors Ltd. for the construction of factory buildings. The work was held up for two months for protest by the farmers.
This may be the basis for a claim.
Now, Tata Motors may raise some objection, so claim should be included in the project revenue only when the amount of claim that is likely to be received can be reliably determined.

Incentive Payments

There may be a clause in a contract that bonus will be given to the contractor for early completion of the project.

When a project is completed before the planned date, the contractor is entitled to get extra money as bonus. They are included in the contract revenue when it can be measured reliably.

Contract Cost

Costs incurred by a contractor can be divided into:

(i) Costs that relate directly to a specific contract;
(ii) Costs that can be attributed to the contract activity in general and can be allocated to specific contracts;
(iii) Costs that relate to the activities of the contractor generally, or that relate to contract activity but cannot be related to specific contracts.

Direct Cost

Costs relating specifically to the contract include :

(i) site labour costs, including supervision;
(ii) materials used for project construction;
(iii) depreciation of plant and equipment required for a contract;
(iv) costs of moving plant and equipment to and from a site;
(v) hiring cost of special plant and equipment;
(vi) consultancy fees that directly relate to the contract;
(vii) contract design cost;
(viii) rectification, guarantee, and expected warranty cost;
(ix) claim from third parties.

Common Cost

Costs that can be attributed to the contract activity in general and can be allocated to specific contracts include the following :

(i) Insurance
(ii) Construction overheads
(iii) Design and technical assistance from central office.

It should be noted that incidental income (e.g., sale of scrap, surplus materials, sale of equipment and plant at the end of the contract) will reduce the contract cost.

Cost Not to be Included

Costs not specifically attributable to any contract incurred by the contractor before a contract is secured will be treated as general overhead and charged to the Profit and Loss Account of the concerned period. Other expenses which will not be treated as contract costs are :

(a) general administration costs;
(b) selling cost;
(c) finance cost;
(d) research and development cost.

Recognition of Contract Revenue and Expenses

In order to estimate an appropriate part of revenue and cost (expense) to be included in the Profit and Loss Account, any of the following two methods can be adopted according to situations :

(i) Percentage of Completion Method
(ii) Completed Contract Method

When a contractor uses a particular method of accounting for a contract then the same method should be adopted for all other contracts which meet similar criteria.

Percentage of Completion Method

Under the percentage of completion method, the amount of revenue recognised is determined by reference to the stage of completion of the contract activity at the end of each accounting period.

For calculating stage of completion, any of the following methods can be adopted by the contractor. The methods are :

(1) the proportion that ***cost incurred to date*** bear to the ***estimated total cost of the contract***. Alternatively, it can be expressed as follows :

$$\frac{\text{Cost incurred for the work up to date}}{\text{Estimated Total Cost}} \times 100$$

Example : Your company X Ltd. has received a contract for construction of a fly over in Delhi. The contract price is ₹ 200 crore and estimated cost is ₹ 160 crore. The company has incurred cost so far worth ₹ 80 crore.

The percentage of completion = $\frac{80 \text{ crore}}{160 \text{ crore}} \times 100 = 50\%$.

(2) ***Surveys of the work done*** : In this case, client's surveyor or independent surveyor survey the progress of the work and issue certificate accordingly.

Example : GMR Ltd. is constructing a stadium at Delhi. The Delhi Government surveyors have confirmed that 40% of the work is completed and recommend payment for the work.

(3) ***Completion of a physical portion of the work*** : Stage of completion can be calculated on the basis of physical completion of the work.

Example : Your company H Ltd has received a contract for building of 150 km, 6 lane highway. Out of 150 km, 100 km has been completed in all respect.

The percentage of completion = $\frac{100 \text{ km}}{150 \text{ km}} \times 100 = 66.67\%$.

The following points are important in respect of above discussion:
(i) Cost to be incurred relating to future work on the contract should not be included in the calculation.
(ii) Progress payments and advanced received from clients often do not reflect the work done.

Under this method '***Contract Revenue***' is recognised as :

Year

1 (Total contract revenue × % of completion) = Revenue to be recognised at the end of 1st year.

2 (Total contract revenue × % of completion) – Revenue recognised in the year 1
= Revenue to be recognised at the end of 2nd year.

3 (Total contract revenue × % of completion) – Revenue recognised in the year 1 and 2
= Revenue to be recognised at the end of 3rd year.

Illustration 1

GMR Infrastructure Ltd. has the following details of a contract that started in 2013.

(i) Contract Value ₹ 10,00,000.

(ii) Percentage of completion :
2013 — 40%;
2014 — 60%;
2015 — 80%.

Calculate the amount of revenue to be recognised in the Profit and Loss Account of 2013, 2014 and 2015.

Solution **Revenue to be Recognised**

Particulars	2013 (₹)	2014 (₹)	2015 (₹)
2011 : 40% of ₹ 10,00,000	4,00,000	—	—
2012 : 60% of ₹ 10,00,000	—	6,00,000	—
2013 : 80% of ₹ 10,00,000	—	—	8,00,000
Less: Revenue recognised in prior periods	—	(4,00,000)	(6,00,000)
Revenue for the period	4,00,000	2,00,000	2,00,000

Note : ***In the Profit and Loss Account, contract revenue is recorded only once. If the contract span is 3 years, we must deduct any contract revenues previously recognised***.

Illustration 2

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 crores 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 recognise this revenue since in the past he has been able to meet similar targets very easily.

Solution

AS—7: "Accounting for Construction Contract" states that incentive payments should be included in contract revenue if the following conditions are satisfied :

(i) the contract is sufficiently advanced and it is probable that the specified performance will be met or exceeded; and

(ii) the amount of the incentive payment can be measured reliably.

In this case, the contract has not even begun and hence Mr. X (the contractor) ***should not recognise any revenue of this contract***.

Applicability of Percentage of Completion Method

The percentage of completion method can be used if the ***outcome*** of the contract can be ***reliably estimated***.

(a) In case of fixed price contracts, this degree of reliability would be provided if the following conditions are satisfied :
   (i) total contract revenues to be received can be reliably estimated;
   (ii) both the costs to complete the contract and the stage of contract performance completed at the reporting date can be reasonably estimated; and
   (iii) the cost attributable to the contract can be clearly identified so that actual expenses can be compared with the prior estimates.

(b) In the case of cost plus contracts this degree of reliability would be provided only if both the following conditions are satisfied :
   (i) cost attributable to the contract can be clearly identified; and
   (ii) costs other than those which are specifically reimbursable under the contract, can be reliably estimated.

Completed Contract Method

Under completed contract method, the recognition of revenue is based on results as determined when the contract is completed or substantially completed.

The main advantage of this method is that the risk of recognising profits that may not have been earned is therefore minimised.

The principal disadvantage of the completed contract method is that periodic reported income does not reflect the level of activity on contracts during the period. For example, when a few large contracts are completed in one accounting period but no contracts have been completed in the previous period or are to be completed in the subsequent period, the level of reported income can be erratic although the level of activity on contracts may have been relatively constant throughout. Even when numerous contracts are regularly completed in each accounting period, and reported income may appear to reflect the level of activity on contracts, there is a continuous lag between the time when work is performed and the related revenue is recognised.

It should be mentioned here that this method is not suitable for long-term contracts. This method is suitable for those contracts which are started and completed within the accounting period.

Recognition of Profits

(a) Profit in case of fixed price contracts normally should not be recognised unless the work on contract has progressed to a ***reasonable extent***. Ordinarily, this test is not considered as having been satisfied unless 20% to 35% of the work is completed.

(b) While recognising the profit under percentage of completion method an appropriate allowance for future unforeseeable factors should be made on either a specific or a percentage basis.

Outcome of the Contract

When the outcome of a contract cannot be estimated the following ***rules must be observed*** :

(1) No profit is to be recognised, though an expected loss should be recognised immediately.
(2) Revenue should be recognised only to the extent of contract costs incurred.
(3) Costs should be recognised in the period in which they are incurred.

Uncertainty over the outcome of the contract may arise from any of the following events :

(a) Financial difficulty of the client

Example : Your company RCC Ltd. has completed 80% work of the new office building of its client R. Securities Ltd. Last installment of payment has not been received from the client. It is the apprehension of the management of RCC Ltd. that this client is in financial trouble and the contract is at risk.

(b) Disputes on reimbursement of costs

Example : Your company Unitech Ltd. is constructing a shopping mall for RPG Ltd. Government officials of fire department is asking for additional fire safety features. Your company has submitted a variation proposals to RPG Ltd. They are not ready to bear the additional cost on the ground that it is contractor's cost.

(c) Anticipated failure to complete the contract in time

Example : Your company L&T Ltd. is executing a 100 km. highway project in Madhya Pradesh. Company's original plan was to work in night shift also. Because of 'Naxalite' problem no night shift work is possible. The management of the company is apprehending that the project will not be completed within the contract period.

Recognition of Foreseeable Losses

A foreseeable loss on the entire contract should be provided for in the financial statements irrespective of:

(i) Whether or not work has started on the contract

Example : Your company X Ltd. has been awarded a contract by HPC Ltd. for building a chemical factory at Haldia, West Bengal. Staff, machinery and materials have been transported to the site. Farmers are protesting for acquisition of farm land. There is no sign of settlement of disputes. The client offers another site, but for the same contract price.
If alternative site is accepted, it will reduce loss, but not eliminate it.
X Ltd. should recognise the loss up to date immediately.

(ii) The stage of completion of the contract or
(iii) The amount of profits expected to arise from other contracts

Example : Your company Simplex Ltd. is constructing 3 shopping malls for RIL at Kolkata, Howrah and Jamshedpur. The company's project at Jamshedpur is hit by labour problems. The company will have to incur extra labour costs and penalties are to be paid for late completion. The management of the company is estimating that there will be a loss of ₹ 50,00,000 in Jamshedpur project but there will be profits in Kolkata and Howrah project of ₹ 2 crore each.
Simplex Ltd. must still recognise the loss on the Jamshedpur project immediately.

Illustration 3

A company took a construction contract for ₹ 100 lakhs in January 2013. It was found that 80% of the contract was completed at a cost of ₹ 92 lakhs on the closing date, i.e., on 31.3.2014. The company estimates further expenditure of ₹ 23 lakhs for completing the contract. The expected loss would be ₹ 15 lakhs. Can the company recognise the loss in the financial statements prepared for the year ended 31st March, 2014 ?

Solution

	₹
Cost upto 31.3.2014	92 Lakhs
Add: Cost to be incurred	23 Lakhs
	115 Lakhs
Less: Contract Price	100 Lakhs
Loss	15 Lakhs

Here, the company should recognise the loss of ₹ 15 lakhs in the Profit and Loss Account for the year ending on 31.3.2014.

Illustration 4

On 1st December, 2013, Viswakarma Construction Company Ltd undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2014 the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of the additional cost for completion was ₹ 32,01,000. What is the additional provision for foreseeable loss which must be made in the final accounts for the year ended 31st March 2014 as per provision of the AS7 on "Accounting for Construction Contracts"?

Solution

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

Here, in the present case, the contract price is ₹ 85 lakhs whereas the costs incurred and costs to be incurred to complete the contract comes to ₹ 97 lakhs (₹ 64.99 lakhs + 32.01 lakhs). Therefore, the probable loss is ₹ 12 lakhs (₹ 97 lakhs – ₹ 85 lakhs). As per the requirement of the AS–7, the company should recognise the ***entire loss of ₹ 12 lakhs*** in the current accounting year.

Illustration 5

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.3.2014. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards:

The company undertook a contract for building a crane for ₹ 10 lakhs. As on 31.3.2014, 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.

Solution

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

Here, in this case, total contract estimated cost is ₹ 10.5 lakhs (₹ 1.5 lakhs + ₹ 9 lakhs), whereas the contract price is ₹ 10 lakhs. Therefore, it is probable that total contract costs will exceed total contract revenue.

As per the requirements of the standard, the foreseeable loss of ₹ 50,000 ***should be recognised as an expense*** in the financial statements of 2013-14.

Illustration 6

A firm of contractors obtained a contract for completion of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2014:

	(₹ in Lakhs)
Total contract price	1,000
Work certified	500
Work not certified	105
Estimated further cost to completion	495
Progress payment received	400
Progress payment to be received	140

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS7 "Accounting for Construction Contracts".

[C.A. — Adapted]

Solution

Here, in this case, the total contract costs exceed total contract revenue. Therefore, there is a foreseeable loss, which is calculated as under:

		₹ in Lakhs
Contract price		1,000
Less: Total contract cost — Incurred (500 + 105)	605	
To be incurred	495	1,100
Anticipated loss on contract		(100)

Calculation of Stage of Completion	₹ in Lakhs
Work certified	500
Work uncertified	105
	605

Therefore, the percentage of completion of contract is : 605/1100 × 100 = 55%.

Amount of contract revenue to be recognised	₹ in Lakhs
55% of contract value	550
Less: Cost incurred to date to complete 55% of contract value	605
Loss to be recognised	55

As per para 35 of AS–7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Therefore, the total loss of ₹ 100 lakhs is to be recognised (₹ 55 lakhs current loss and ₹ 45 lakhs anticipated future loss) as an expense in the financial statements during 2013-14.

Illustration 7

X Limited received a contract for ₹ 10,00,000 which required 3 years to complete and incurred a total cost of ₹ 8,10,000.

The following information is available in regard to the contract (all figures in ₹) :

	Year 1	Year 2	Year 3
Costs incurred to date	3,00,000	7,20,000	8,10,000
Estimated costs to be incurred	6,00,000	80,000	—
Progress billing made	2,00,000	7,40,000	6,00,000
Cash received	1,50,000	6,00,000	2,50,000

The company seeks your advice in the presentation of accounts keeping in view the requirements of AS7.

Solution **Calculation of Estimated Profit** [figures in ₹]

	Year 1	Year 2	Year 3
Contract Price (A)	10,00,000	10,00,000	10,00,000
Contract Cost —incurred	3,00,000	7,20,000	8,10,000
to be incurred	6,00,000	80,000	—
Estimated Contract Cost (B)	9,00,000	8,00,000	8,10,000
Estimated Profit [(A) – (B)]	1,00,000	2,00,000	1,90,000

Calculation of Stage of Completion

Year 1	Year 2	Year 3
$\frac{3,00,000}{9,00,000} \times 100 = 33\frac{1}{3}\%$	$\frac{7,20,000}{8,00,000} \times 100 = 90\%$	$\frac{8,10,000}{8,10,000} \times 100 = 100\%$

Calculation of Revenue and Expenses Recognised in the Financial Statements

	Year End	Recognised in Previous Year(s)	Recognised in Current Year
Year 1			
Revenue ($33^1/_3$% of ₹ 10,00,000)	3,33,333	—	3,33,333
Expenses ($33^1/_3$% of ₹ 8,10,000)	2,70,000	—	2,70,000
Profit	63,300	—	63,333
Year 2			
Revenue (90% of ₹ 10,00,000)	9,00,000	3,33,333	5,66,667
Expenses (90% of ₹ 8,10,000)	7,29,000	2,70,000	4,59,000
Profit	1,71,000	63,333	1,07,667
Year 3			
Revenue (100% of ₹ 10,00,000)	10,00,000	9,00,000	1,00,000
Expenses (100% of ₹ 8,10,000)	8,10,000	7,29,000	81,000
Profit	1,90,000	1,71,000	19,000

Disclosure

There should be disclosure in the financial statements of

i. the amount of construction work-in-progress;

ii. progress payments received and advances and retentions on account of contracts included in construction work-in-progress; and

iii. the amount receivable in respect of income accrued under cost plus contracts not included in construction work-in-progress.

If both the percentage of completion method and the completed contract method are simultaneously used by the contractor the amount of contract work described in (i) above should be analysed to disclose separately the amounts attributable to contracts accounted for under each method.

Disclosure of changes in an accounting policy used for construction contracts should be made in the financial statements giving the effect of the change and its amount. However if a contractor changes from the percentage of completion method to the completed contract method for contracts in progress at the beginning of the year it may not be possible to quantify the effect of the change. In such cases disclosure should be made of the amount of attributable profits reported in prior years in respect of contracts in progress at the beginning of the accounting period.

Illustration 8

X Limited has four contracts, P, Q, R and S, which are in progress. All the contract costs incurred have been paid for in cash, as well as, all its progress billings and advances have been received in cash. Contract costs incurred include the cost of materials that have been purchased for the respective contracts, but which have not been used in contract performance upto the end of the year. For contracts P, Q and S the contractors have paid advances to X Limited for work not yet performed.

The status of the contracts at the end of year 1 is as under : [figures in ₹]

Particulars	P	Q	R	S	Total
(a) Contract revenue	1.400	800	600	200	3.000
(b) Contract expenses	1.200	700	700	200	2.800
(c) Anticipated losses recognised	—	—	100	40	140
(d) Profit / (Loss)	200	100	(200)	(40)	60
(e) Contract costs incurred during the period	1.300	740	700	220	2.960
(f) Contract costs incurred recognised as expenses	1.200	700	700	200	2.800
(g) Contract costs that relate to future activity recognised as an asset (e – f)	100	40	—	20	160
(h) Progress billings	1.400	800	600	150	2.950
(i) Unbilled contract revenue	—	—	—	50	50
(j) Advances	100	40	—	—	140

How should X Limited disclose the information in the financial statements for the year so as to comply with AS–7?

Solution **Calculation of Basic Information** (₹ in Lakhs)

Particulars		P	Q	R	S	Total
Contract cost to date	(a)	1,300	740	700	220	2.960
Profit / (Loss) recognised	(b)	200	100	(200)	(40)	60
Contract cost plus recognised profit / (loss)	(a + b) – A	1.500	840	500	180	3,020
Progress billings	B	1,400	800	600	150	2.950
Debtors	(A – B)	100	40	—	30	170
Creditors	(B – A)	—	—	(100)	—	(100)

Disclosure in Financial Statements (₹ in Lakhs)

The amount of contract revenue recognised as revenue in the period	3,000
The aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date	3,020
The amount of advanced received	140
The gross amount due from customers for contract work as an asset (debtors)	170
The gross amount due to customers for contract work as a liability (creditors)	(100)

OBJECTIVE TYPE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Cost-plus contract is a contract in which price is
   A agreed upon in advance
   B not agreed upon in advance
   C agreed upon in advance but subject to change in future
2. Contract revenue should comprise
   A all cash flows
   B initial revenue agreed *plus* variations, claims and incentive payments and proceeds from sale of scrap
   C initial revenue agreed, plus variations, claims and incentive payments
3. Incidental income, such as from the sale of scrap income, should be shown as
   A contract revenue
   B deduction from cost
   C other income in the profit and loss account
4. A foreseeable loss on the entire contract should be
   A recognised at the end of the contract
   B recognised immediately
   C spread over the remaining period of the contract

Guide to Answers

1. B **2.** C **3.** B **4.** B **5.** A.

AS — 9 : Revenue Recognition
[Effective Date : 1st April, 1991]

Introduction
Determination of profit is influenced by the revenue recognition policy of the enterprise. In principle, revenue can be recognised at the point of sale or when cash is collected or at any intermediate point. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction.

This statement deals with the basis for recognition of revenue in the Profit and Loss Account of the enterprise. It is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from :

(i) the sale of goods
(ii) the rendering of services
(iii) the use by others of enterprise resources yielding interest, royalties and dividends.

Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

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

(i) revenue arising from construction contracts (subject matter of AS–7);
(ii) revenue arising from hire-purchase, lease agreements (subject matter of AS–19);
(iii) revenue arising from government grants and other similar subsidies (subject matter of AS–12); and
(iv) revenue of insurance companies arising from insurance contracts.

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

Completed Service Contract Method
Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

Proportionate Completion Method
Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.

Sale of Goods
Revenue from sale of goods is recognised when all the following conditions have been satisfied :

1. the seller of goods has transferred to the buyer the property in the goods for a price;
2. all significant risks and rewards of ownership have been transferred to the buyers;
3. the seller retains no effective control of the goods transferred to a degree usually associated with ownership;
4. no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Example 1: Modern Furnitures (P) Ltd. sold a computer table to Ram for ₹ 6,000. Ram paid it by credit card.
Modern Furnitures (P) Ltd. will recognise ₹ 6,000 as revenue immediately.
Example 2 : Computer Point (P) Ltd. sold 10 computers to St. Xavier's College, Kolkata for ₹ 3,00,000 on credit. Here Computer Point will recognise the revenue of ₹ 3,00,000 immediately because normal credit risk derived from sales is not a reason to defer revenue recognition.

Illustration 1

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 finalisation, is it possible to recognise the sale and gain at the Balance Sheet date ?

Solution

According to AS—9 "Revenue Recognition" it is possible for Bottom Ltd. to recognise the sale and gain at the Balance Sheet date. It is clear that the significant risk and rewards of ownership has passed before Balance Sheet date and the registration of the property is merely a formality.

Transfer of Legal Title

It should be noted that the transfer of legal title normally passes the risks and rewards. However, there are certain cases in which risks and rewards do not get transferred to the buyer with the transfer of legal title or passing of possessions.

For example :

1. If the sale of contract allows the goods to be returned and you cannot reasonably estimate the probability of return, the sale should not be recognised until you are sure about the acceptance by the customer.
2. If installation is an important part of the sale, recognition of revenue does not takes place until installation is complete.
3. If the sale is contingent on the buyer deriving revenue from resale of the goods, revenue is recognised at the time of resale only.

Example : In January, 2015 Tata Motors Ltd. supplied 10 Indica cars to its agent, Lexus Motors (P) Ltd. on consignment basis. The selling price was ₹ 4,00,000 each and commission is payable @ 10% on sales. By 31st March, 2015, Lexus Motors sold 5 cars only.
Here, revenue of ₹ 20,00,000 only will be recognised in March 2015.
Sales commission of ₹ 2,00,000 also will be recognised as expense in March 2015.

Illustration 2

How would you deal with the following in the annual accounts of a Company, for the year ended 31.3.2015:

Some of the transport claims, lodged in 2012-13 has been settled by the Carrier in February 2015 by paying ₹ 1.15 lakhs. These claims were not recorded in the books of the Company so far.

Solution

Since the amount has been received, the revenue is measurable. Therefore, the Company should recognise this as revenue in the current year, as part of net income. The Company was correct in not providing for the same as revenue, when the claim was lodged.

Illustration 3

How will you deal with the following:

The Board of Directors decided on 31.3.2015 to increase the sale price of certain items retrospectively from 1.1.2013. In view of this price revision, w.e.f. 1.1.2015, the Company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1.1.2015 to 31.3.2015 and the accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2014-15.

Solution

Recognition of revenue requires that it would not be unreasonable to expect ultimate collection. In other words, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made.

Here, in this case, the additional revenue arising out of price revision can be recognised as revenue in the current year provided there is certainty relating to collectibility.

Illustration 4

TVSM Company has taken a Transit Insurance Policy. Suddenly in the year 2014-15, the percentage of accident has gone up to 7% and the Company wants to recognise insurance claim as revenue in 2014-15 in accordance with relevant accounting standard. Do you agree?

Solution

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise. As per AS–9, recognition of revenue requires that revenue is measurable and it would not be unreasonable to expect ultimate collection.

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made.

Another essential criterion for the recognition of revenue is that the consideration receivable is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

Therefore, in the present case, the Company should ***postpone the revenue recognition*** as there are uncertainties in the settlement of insurance claim.

Illustration 5

Arjun Ltd. sold farm equipments through its dealers. One of the conditions at the time of sale is, payment of consideration money in 14 days and in the event of delay interest is chargeable @ 15% p.a. The company has not realised interest from the dealers in the past. However, for the year ended 31.3.2006, it wants to recognise interest due on the balances due from dealers. The amount is ascertained at ₹ 9 lakhs. Decide whether the income by way of interest from dealers is eligible for recognition as per As—9 ? ***[C.A. (PE-II) — May, 2006]***

Solution

As per AS—9, recognition of revenue requires that revenue is measurable and it would not be unreasonable to expect ultimate collection.

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made.

In this case, the company should not recognise ₹ 9 lakhs as interest income for the year ending on 31.3.2006 because there is uncertainty in respect of collection of interest.

The company should postpone the recognition until the collection of interest is made.

Rendering of Services

Revenue from rendering of services should be recognised by referring to the stage of completion at the Balance Sheet date. There are two methods for dealing with this situation :

(i) Proportionate Completion Method; and (ii) Completed Service Contract Method

(i) Proportionate Completion Method

Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the ***basis of contract value, associated costs, number of acts*** or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

Example : Your company Hindustan Constructing Co. Ltd. (HCCL) is laying a city gas pipe line for its client REL. Total revenue of the project is ₹ 40,00,000.
HCCL has incurred cost up to 31st March, 2015 ₹ 15,00,000 and the company is expecting that ₹ 10,00,000 more will be required to complete the project.
Upto 31st December, 2014 REL has approved ₹ 12,50,000 of expenditure. HCCL is confident that the balance ₹ 2,50,000 (₹ 15,00,000 – ₹ 12,50,000) will be approved by REL when their engineer will inspect the work during the 1st week of April, 2015. No payment has been received so far.
Recognise :
(a) ₹ 12,50,000 as expenses (the amount approved)
(b) ₹ 20,00,000 as (accrued) revenue

$$\frac{12{,}50{,}000}{25{,}00{,}000} \times ₹\ 40{,}00{,}000$$

(ii) Completed Service Contract Method

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

Interest, Royalty and Dividends

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectibility exists. These revenues are recognised on the following basis:

(i) ***Interest*** : on a time proportion basis taking into account the amount outstanding and the rate applicable;
(ii) ***Royalties*** : on an accrual basis in accordance with the terms of the relevant agreement;
(iii) ***Dividends from Investments in shares*** : when the owner's right to receive payment is established.

Illustration 6

SCL Limited sells agricultural products to dealers. One of the condition of sale is that interest is payable @ 2% p.m. for delayed payment. Percentage of interest recovered is only 10% on such overdue outstanding due to various reasons. During the year 2014-15, the Company wants to recognise the entire interest receivable. Do you agree?

Solution

Revenue arising from the use by others of enterprise resources yielding interest, should only be recognised when no significant uncertainty as to measurability or collectibility exists. Interest is recognised as revenue on the following manner:

On a time proportion basis taking into account the amount outstanding and the rate applicable.

Here, in this case, as the uncertainty arises regarding collectibility of interest. The company should not recognise it as revenue of 2014-15. However, company can recognise it when cash will be received.

Illustration 7

Y Co. Ltd. used certain resources of X Co. Ltd. In return, X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respectively from Y Co. Ltd. during the year 2014-15.

You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

Revenue is measured by the charges made to customers for the use of resources by them. The use by others of such enterprise resources gives rise to —

(i) **Interest —** charges for the use of cash resources or amounts due to the enterprise.

Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable.

(ii) **Royalties —** charges for the use of such assets as know-how, patents, trade marks and copyrights.

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

Here, X & Co. Ltd. should recognise ₹ 25 lakhs as revenue for the year 2014-15.

Disclosure

In addition to the disclosure required by Accounting Standard 1 on ***Disclosure of Accounting Policies*** (AS-1), an enterprise also has to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Specific Examples

Sale of Goods

1. **Delivery is delayed at buyer's request and buyer takes title and accepts billing**

In this case, revenue should be recognised though the physical delivery has not been done. However, the following conditions must be satisfied :

(i) the item must be on hand and (ii) the item is identified and ready for delivery

Example : Your company PP Ltd. is about to deliver the boiler to its client CESC Ltd. The site of the client is not yet ready for strike by the casual labours. CESC Ltd. requested PP Ltd. to hold the boiler at their risk until the site is ready.
The revenue is recognised immediately as the title to the goods and risk has passed to CESC Ltd.

2. **Delivered subject to Conditions**

(a) ***Installation and Inspection***: If the contract specifies delivery, installation and inspection, all must be completed to recognise revenue.

Example : HMT Ltd. sold a printing press to Swapna Printers Ltd. for ₹ 50,00,000. As per contract, the payment will be made only after successful installation and trial run. Revenue will not be recognised unless the installation and trial run has been done up to the satisfaction of the customer.

If the installation is very simple, revenue may be recognised on delivery.

Example : Your company, Sony India (P) Ltd. sells colour television to different customers through retail chain "Sony World". All televisions are factory tested. For installation, it requires unpacking and connecting to power plug and dish antennae cables.
Revenue can be recognised at the time of delivery only.

(b) ***On approval*** : Revenue is recognised if the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has passed or where no time has been fixed, a reasonable time has been passed.

Example : Your company, "Modern Toys" sell electronic toys to retailers. Written communication must be made within 15 days.
After 15 days, if nothing has been rejected the revenue can be recognised.

(c) ***Guaranteed sales, i.e., delivery is made by giving the buyer an unlimited right of return*** : Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience.

(d) ***Consignment Sales***: Revenue should not be recognised until the goods are sold to a third party.

(e) ***Cash-on-delivery sale***: Revenue is recognised when delivery is complete and cash has been received by the seller or his agent.

Example : Your company "Amazon.com" sell books via internet. Customers can pay on receipt of the book. Revenue can be recognised when books have been delivered and cash has been collected by the agent on behalf of the seller.

3. **Payment by Installments followed by Delivery**

Sales where buyer makes a series of installment payments to the seller, and the seller delivers the goods only when the final payment is received.

Revenue is recognised when goods are delivered. However, when experience indicates that most customers pay all of their installments, revenue may be recognised when a significant deposit is received and the goods are ready for delivery.

Example : Your company "Ultra Soft" is developing an accounting software for its client. Price of the software is ₹ 5,00,000. As per contract, a series of payment is to be made with the progress of the work. The software is ready for delivery and so far your company has received 95% of the total price and the balance 5% is expected any time.
Revenue can be recognised fully at present.

4. **Special Order and Shipment**

When payment has been received in advance from customers for goods still to be manufactured or is to be delivered directly to the customer from a third party.

Revenue from such sales should be recognised when the goods have been manufactured, identified and ready for delivery to the buyer by the third party.

5. **Sales and Repurchases of Same Item**

Some items are sold on the condition that it will be repurchased after some time. These transactions are really financing transactions. The ***resulting cash flow will not be treated as revenue***.

Example : Your company, R.K. Securities has sold 1,000 shares of RIL @ ₹ 2,600 to Ganesh in May, 2015 on the condition that all these shares are to be repurchased after 6 months @ ₹ 2,700.
This is basically a finance transaction and no revenue should be recognised.

6. **Sales to Intermediate Parties**

Sometimes goods are sold to distributors, dealers or others for resale.

Revenue from such sales can generally be recognised if significant risks of ownership have passed.

7. **Subscriptions for Publication**

Recognise revenue on a straight line basis over time. If the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales volume of all items covered by the subscription.

8. **Installment Sales**

When the consideration is receivable in installments, revenue attributable to the sale price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

Example : On 1st January, 2014 A sells a mini truck to B, on the installment payment system, on the following terms and conditions :

(a) The cash selling price is ₹ 1,00,000.

(b) The amount payable to A in four equal annual installments along with 12% interest p.a. on the outstanding balance, the first installment being payable on the date of sale.

Recognise immediately ₹ 1,00,000 as revenue.

Interest will be recognised as follows :	**₹**
2014 — 12% of (₹ 1,00,000 – ₹ 25,000)	**9,000**
2015 — 12% of (₹ 75,000 – ₹ 25,000)	**6,000**
2016 — 12% of (₹ 50,000 – ₹ 25,000)	**3,000**

9. **Trade Discounts and Value Rebate**

Trade discounts and value rebates are not revenue. They represent a reduction of cost.

Rendering of Services

1. **Installation Fees**

When installation fees are charged separately, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

If the job consists of the excecution of more than one act, revenue is recognised proportionately.

Example : Your company, "Compu Data Services (P) Ltd." is installing a computer network in 10 identical buildings for a customer, under a single contract.
Recognise 10% of the revenue on completion of installation in each building.

2. **Advertising and Insurance Agency Commissions**

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency.

Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. **Financial Service Commissions**

The following matters should be taken into account before recognition of revenue from financial service commissions. These are :

(i) whether the service has been provided "once and for all" or on a "continuing basis" ?
(ii) the incidence of costs relating to the service;
(iii) when the payment for service will be received ?

Revenue from financial service commissions are recognised in the following manner :

(a) Commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into.

Example : Your company, SBI Housing Finance Ltd., has given a housing loan to Robin of ₹ 20,00,000. Processing fee is payable @ 0.1% on the loan amount.
As and when loan agreement will be signed between SBI Housing Finance Ltd. and Robin, ₹ 2,000 will be recognised as revenue by the company.

(b) Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. **Admission Fees**

Revenue from artistic performances, banquets and other special events should be recognised when the event take place. When a subscription to a number of event is sold, the fees should be allocated to each event on a systematic and rational basis.

5. **Tuition Fees**

Revenue should be recognised over the period of instruction.

6. **Entrance and Membership Fees**

Revenue recognition from these sources will depend upon the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fees should be recognised when received.

If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

Example : To become a student member of National Library, you have to pay ₹ 500 as entrance fee and ₹ 1,200 as annual membership fee.
Entrance fee of ₹ 500 will be capitalised and the annual membership fee will be recognised as revenue @ ₹ 100 per month by the National Library.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. When is a sale recognised ?
   A when cash is collected from customer
   B when certain conditions have been satisfied
   C whenever the seller decides to recognise it
2. Revenue
   A includes government grants and other subsidies
   B includes sales tax and VAT
   C is the gross inflow of cash receivables or other consideration arising in the course of the ordinary activities
3. Trade discounts and volume rebate should
   A be recognised as revenue
   B be ignored
   C be subtracted from cost
4. Normal credit risk derived from sales
   A is a reason to defer revenue recognition
   B is not a reason to defer revenue recognition
   C is disclosed in the directors' report
5. If the installation is an important part of the sales;
   A revenue recognition take place when goods are delivered at the site
   B recognition of revenue will take place at the end of the accounting period
   C recognition of revenue does not take place until installation is complete
6. Revenue from rendering of services should be recognised by referring the stage of completion
   A at the end of the calendar year
   B at the balance sheet date
   C none of the above

7. Once a credit sale has been recognised as revenue any risk of non-payment is treated as
   A a reduction in revenue
   B a finance charge
   C a bad or doubtful debt expenses
8. Interest revenue should be recognised on a
   A cash basis
   B time proportion basis taking into account the rate applicable
   C time proportion basis taking into account the amount outstanding and the rate applicable
9. Royalties revenue should be recognised
   A on an accrual basis in accordance with the terms of the relevant agreement
   B on a cash basis
   C on an actual basis
10. Dividends from investments in shares should be recognised
   A on a cash basis
   B when the shareholders' right to receive payment is established
   C on an accrual basis

Guide to Answers

1. B; **2.** C; **3.** C; **4.** B; **5.** C; **6.** B; **7.** C; **8.** C; **9.** A; **10.** B

AS — 10 : Accounting for Fixed Assets
[Effective Date : 1st April, 1991]

Introduction

Fixed assets represent a significant portion of the total assets of an enterprise. In some industries like iron and steel, oil refinery etc., fixed assets consist of 70% to 80% of the total assets. Therefore, fixed assets are very important in the presentation and preparation of financial statements. Furthermore, the operating profits of an enterprise will depend upon whether an expenditure represents an asset or an expense.

This statement deals with accounting for fixed assets. Generally, fixed assets are grouped into various categories, e.g., land, building, plant and machinery, furniture and fixtures, vehicles, patents, trade marks, etc.

Objectives

The main objectives of this statement are :

(a) the recognition of the fixed assets; and
(b) determining their carrying amounts.

Scope

1. This statement does not deal with accounting for the following items to which special considerations apply :
   (a) forests, plantations and similar regenerative natural resources;
   (b) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-generative resources;
   (c) expenditure on real estate development; and
   (d) livestock.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (a) to (d) above, but separable from those activities, are to be accounted for in accordance with this statement.

Example : Irrigation equipments used for plantation are to be accounted for in accordance with this statement, though plantations is outside the scope of this statement.

2. This statement does not deal with the ***accounting for depreciation*** of the fixed assets.
3. This statement does not deal with the ***treatment of government grants and subsidies*** and assets under ***leasing rights***.

Definitions

Fixed Assets

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

Fair Market Value

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

Gross Book Value

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

Identification of Fixed Assets

An asset will be accounted for as a ***fixed asset*** if the following conditions are satisfied :

(a) It is held with the intention of being used for the purpose of producing or providing goods and services; and

(b) It is not held for sale in the normal course of business.

In some cases, an enterprise may treat an item as expense though it would otherwise be classified as fixed asset.

It is done because the amount of the expenditure is not material.

Example : Saraswati Printers (P) Ltd purchased a punching machine for ₹ 500. Life of the punching machine is 5 years. As the amount of expenditure is small, it can be treated as an expense instead of recording it as a fixed asset.

It should be noted that the Standard permits the aggregation of individually insignificant items, such as tools, modules and dies, as one fixed asset.

Stand-by Equipment and Servicing Equipment

Stand-by equipment and servicing equipment are accounted for as fixed assets.

Example : Factory washing machine and stand-by generator are fixed assets.

Spare Parts

Regularly used spare parts are usually carried as inventory. It is charged to Profit and Loss Account when consumed.

However, if spare parts can only be used in connection with an item of fixed asset and their use is expected to be irregular, they are accounted for as ***fixed assets***. They are depreciated on a systematic basis over the useful life of the ***principal fixed asset***.

Component Accounting

In certain circumstances, the accounting for an item of fixed asset should be done on the basis of its ***separable components***, if

(a) they are in practice separable;

(b) their useful lives are different.

Example : Instead of treating an aircraft and its engines as one unit, it will be better to treat engines and aircraft as separate units. The useful life of engines are usually shorter than that of the aircraft. It should be noted that separate recognition will lead to better estimation of depreciation.

Components of Cost

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

Examples of directly attributable costs are:

(i) site preparation;

(ii) initial delivery and handling costs;

(iii) installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees of architects and engineers.

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

Modvat Credit

Modvat credit is a refund of excise duty. Modvat credit is deducted from the cost of the fixed asset provided certain conditions are satisfied.

Start-up and Commissioning Costs

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e. production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

Illustration 1

A company is in the process of setting up a production line for manufacturing a new product. Based on trial runs conducted by the company, it was noticed that the production lines output was not of the desired quality. However, the company has taken a decision to manufacture and sell the sub-standard product over the next one year due to the huge investment involved.

In the background of the relevant accounting standard, advice the company on the cut-off date for capitalisation of the project cost.

Solution

The cut-off date for capitalisation of the project cost would be the date when the ***trial run was completed***. Here, the company has taken a decision to manufacture and sell the sub-standard product over the next one year due to huge investment involved. Any loss incurred on sale of sub-standard product will not be capitalised but to be charged to Profit and Loss Account.

Compensation from the Supplier of the Fixed Asset

Sometimes, as per the terms and conditions of the contract, an enterprise may receive compensation from the supplier of the fixed asset. The amount of compensation will be deducted from the cost of the fixed asset. However, if the enterprise is receiving any penalty also from the supplier, it should be credited to Profit and Loss Account.

Administration and Other General Overhead

Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.

Example 1 : Goodricke Ltd is planning to set up a plant for instant tea in Assam. To explore the possibility of getting special equipment, the managing director of the company visited China. During this trip, MD short-listed two manufacturers and negotiation is going on for different matters. The company had incurred ₹ 1,00,000 as expense for this trip. This expense should be charged to Profit and Loss Account because the cost do not relate to a specific fixed asset.

Example 2 : Let us assume that Goodricke Ltd had placed an order with a manufacturer for supply of the equipment. The chief engineer visited China to inspect the equipment before despatch. The company incurred ₹ 80,000 for this visit.

This ₹ 80,000 forms part of the cost of the equipment as it is directly attributable.

Commercial Production

If the interval between the date of a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

Self-Constructed Fixed Assets

In arriving at the cost of self-constructed fixed asset, the same principles apply as for an acquired asset. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

Exchange of Fixed Assets

(i) When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either :

(a) at fair value; or

(b) at the net book value of the assets given up, adjusted for any balancing payment or receipt of cash or other consideration.

For those purposes 'fair value' may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident.

(ii) When a fixed asset is acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value or the fair market value of the securities issued whichever is more clearly evident.

Example: On 1st January, 2012 P. Ltd. purchased a roasting machine for ₹ 60,000. On 1st January, 2014 the roasting machine got out of order and new roasting machine was purchased after surrendering old one and paying cash of ₹ 90,000. The cost of the new machine in the market is ₹ 1,20,000. Rate of depreciation is 20% and residual value is nil.

Here, new roasting machine purchased on 1st January, 2014 will be recorded at ₹ 1,20,000 because fair value of asset acquired is more clearly evident (see (a) below)

(a) Fair value (which is market price)		**₹ 1,20,000**
(b) Net book value of the asset given up (₹ 60,000 – 24,000)	**36,000**	
Add: Balance payment	**90,000**	**₹ 1,26,000**

Subsequent Expenditure

Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the ***future benefits*** from the existing asset beyond its previously assessed standard of performance.

Illustration 2

On 1.1.2011, X Ltd. purchased a plant at a cost of ₹ 1,80,000. Additionally, installation costs totalled ₹ 20,000. During 2013, major repairs costing ₹ 31,500 had been carried out on this plant. In order to increase the capacity of the plant, a new motor had been fitted on 1.1.2014 at a cost of ₹ 22,000. A further overhauling cost of ₹ 13,500 had been carried out during 2014. You are required to determine the cost of the plant at different years (assume rate of depreciation 10% on straight-line basis).

Solution

(i) Cost of Plant on 1 January, 2011	₹
Purchase price	1,80,000
Add: Installation costs	20,000
	2,00,000

(ii) Book Value on 1 January, 2012

After depreciation for 2011 @ 10% on ₹ 2,00,000 = ₹ 1,80,000.

(iii) Book Value on 1 January, 2013

After depreciation for 2012 @ 10% on ₹ 2,00,000 = ₹ 1,60,000.

(iv) Cost of Plant on 1 January, 2014	
Book value on 1.1.2014 (₹ 160,000 – 20,000)	1,40,000
Add: **Cost of new motor**	22,000
	1,62,000

Tutorial Note : Major repairs in 2013 costing ₹ 31,500 are to be treated as revenue expenses and are to be charged to Profit and Loss Account. Similarly, overhauling cost of ₹ 13,500 in 2014 is to be treated as revenue expenses and it is to be charged to the Profit and Loss Account of that year.

Illustration 3

During the current year 2014-15, X Limited made the following expenditure relating to its plant building:

	₹ in Lakhs
Routine Repairs	4
Repairing	1
Partial replacement of roof bills	0.5
Substantial improvements to the electrical wiring system which will increase efficiency	10

What amount should be capitalised?

Solution

As per para 12.1 of AS—10, only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

Here, in this case, repairs of ₹ 5 lakhs and partial improvement of ₹ 50,000 do not meet the above criterion. Therefore, these should be charged to Profit and Loss Account as expenses. But, substantial improvements to the electrical wiring system which will increase efficiency will be capitalised, i.e., ***added*** to the cost of the plant.

Retirements and Disposals

Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.

Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement.

Example: Swapna Printers (P) Ltd. replaced its offset printing machine with a modern Web Printing Machine during the year 2013-14.

The book value of the offset printing machine is ₹ 5,00,000 but it can be sold as scrap for ₹ 3,00,000 (net) only. Negotiation is going on with two buyers. Till the end of the accounting year (31st March, 2014) nothing has been finalised.

At the time of preparation of financial statements for the year 2013-14, this machine will be shown in the Balance Sheet at ₹ 3,00,000 and to be disclosed separately. The loss of ₹ 2,00,000 (₹ 5,00,000 – 3,00,000) will be recognised as expenses and to be charged to the Profit and Loss Account of 2013-14.

Revaluation of Tangible Fixed Assets

When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed.

Points to be noted:

(1) If an item is revalued, the entire class to which that asset belongs will also be revalued.

(2) A class is a grouping of assets of a similar nature and use (e.g., land, building, plant and machinery, furnitures and fixtures, etc.).

(3) Revaluation should not be selective but carried out in a methodical and organised manner. For example, an enterprise may revalue all the fixed assets within an unit.

The revaluation in financial statements of a class of assets should not result in the net book value of that class beyond the recoverable amount of assets of that class.

The ***recoverable amount*** is the higher of the following :

(i) an asset's net selling price; or

(ii) its value in use*

Example

We consider the following example (all figures in ₹) :

Assets	A	B	C
Net book value (before revaluation)	10,000	12,000	15,000
Recoverable amount	12,000	15,000	8,000

If the business decides to revalue assets A and B but not C, the position will be as under :

Assets	A	B	C	Total
Net book value (after revaluation)	12,000	15,000	15,000	42,000
Recoverable amount	12,000	15,000	8,000	35,000

Here, the net book value is more than the recoverable amount. This is not permissible under the standard.

Surpluses / Deficits on Revaluation

An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

An increase in net book value arising on revaluation of a fixed asset is to be recorded by debiting the Asset Account and crediting the Revaluation Reserve Account. Conversely, a decrease in net book value arising on revaluation of a fixed asset is to be recorded by debiting Profit and Loss Account and crediting Asset Account.

A fixed asset which was revalued downwards in a previous accounting period, may be revalued upwards in the current accounting period. In such a case, the previous decrease is to be adjusted against the current increase by crediting Profit and Loss Account. The surplus balance, if any, is to be transferred to Revaluation Reserve Account.

For example, an asset is revalued downwards in 2013 by ₹ 5,000, debiting the Profit and Loss Account and crediting the Asset Account. In 2014, the same asset is revalued upwards by ₹ 7,000. Here, Asset Account is to be debited by ₹ 7,000, Profit and Loss Account is to be credited by ₹ 5,000 and Revaluation Reserve Account to be credited by ₹ 2,000.

On the other hand, a fixed asset which was revalued upwards in a previous accounting period, may be revalued downwards in the current accounting period. In such a case, the previous increase is to be adjusted against the current decrease by debiting Revaluation Reserve Account. The deficit balance, if any, is to be transferred to Profit and Loss Account.

For example, an asset is revalued upwards in 2013 by ₹ 5,000, debiting the Asset Account and crediting Revaluation Reserve Account. In 2014, the same asset is revalued downwards by ₹ 7,000. Here, Revaluation Reserve Account is to be debited by ₹ 5,000, Profit and Loss Account is to be debited by ₹ 2,000 and Asset Account is to be credited by ₹ 7,000.

Illustration 4

How will you treat the following ?

A revaluation of land and building of a firm during the year showed surpluses totalling ₹ 40,00,000 and a revaluation of plant and machinery showed deficits totalling ₹ 5,00,000. The firm's revaluation reserve of ₹ 65,00,000 includes previous revaluation surpluses of ₹ 2,00,000 on plant and machinery now showing a deficit on revaluation.

*It is the present value of estimated future cash flows expected to arise from the continuing use of a fixed asset over its useful life and from its ultimate disposal.

Solution

The revaluation surplus of ₹ 40,00,000 must be taken directly to revaluation reserve. The revaluation deficit of ₹ 5,00,000 will be taken to the Profit and Loss Account to the extent that it is not covered by previous unrealised surpluses on the same assets. Thus ₹ 2,00,000 will be adjusted against revaluation reserve and the remaining ₹ 3,00,000 written-off to the Profit and Loss Account, **being disclosed as an exceptional item**.

Sale of Previously Revalued Assets

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

The amount standing in Revaluation Reserve following the retirement or disposal of an asset which relates to that asset may be transferred to General Reserve.

Example: The net book value of an asset is ₹ 10,000 which is disposed off for ₹ 6,000. The asset was previously revalued upwards by ₹ 3,000. Here, the loss of ₹ 4,000 (₹ 10,000 – 6,000) is to be adjusted first by debiting Revaluation Reserve (₹ 3,000) and the balance by debiting Profit and Loss Account (₹ 1,000).

It should be noted that if the Revaluation Reserve Account in respect of that asset has already been reversed or utilised, no adjustment against Revaluation Reserve Account is possible. In this case, the entire amount is to be debited to Profit and Loss Account.

Jointly Owned Fixed Assets

In the case of fixed assets owned by the enterprise jointly with others, the extent of the enterprise's share in such assets, and the proportion of the original cost, accumulated depreciation and written-down value should be stated in the Balance Sheet. Alternatively, the pro rata cost of such jointly owned assets may be grouped together with similar fully-owned assets with an appropriate disclosure thereof.

Purchase of Several Fixed Assets for a Consolidated Price

Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to the various assets on a fair basis as determined by competent valuers.

Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as "goodwill".

Disclosures

The following information should be disclosed in the financial statements:

(i) gross and net book values of fixed assets at the beginning and end of an accounting period, showing additions, disposals, acquisitions and other movements;

(ii) expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(iii) revalued amount substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. AS—10: 'Accounting for Fixed Assets' deal with accounting for the following items :
   A forest, plantations and solar energy
   B livestock
   C equipments used for plantations
2. Regularly used spare parts are usually
   A treated as expense on purchase
   B carried as inventory and treated as an expense on consumption
   C treated as a fixed asset and depreciated accordingly
3. Standby equipment and servicing equipments are
   A ignored
   B accounted for as current assets
   C accounted for as fixed assets
4. Modvat credit is
   A added with the cost of the fixed asset
   B deducted from the cost of the fixed asset without any condition
   C deducted from the cost of the fixed asset if certain conditions are satisfied
5. The expenditure incurred on test runs is usually
   A capitalised as a direct element of the construction cost
   B capitalised as an indirect element of the construction cost
   C treated as revenue expenditure
6. The expenditure incurred between the date of a project is ready to commence commercial production and the date of actual commercial production will be
   A capitalised
   B ignored
   C charged to Profit and Loss Account
7. Individually-insignificant items, such as moulds, tools and dies may be
   A expensed on purchase
   B aggregated as one asset
   C ignored
8. Components of cost are
   (i) purchase price
   (ii) general office overheads
   (iii) any costs directly attributable to bringing the asset to its working condition for its intended use
   A all the above
   B all except (iii)
   C all except (ii)
9. When a fixed asset is acquired in exchange for another asset, the cost of the asset acquired should be recorded
   A at replacement cost
   B at fair value
   C at the net book value of the asset given up only
10. Subsequent expenditures related to an item of fixed asset should be added to its book value
   A only if it is recommended by the auditors
   B only if it is recommended by the Board of Directors
   C only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.

Guide to Answers

1. C; **2.** B; **3.** C; **4.** C; **5.** B; **6.** C; 7. B; **8.** C; **9.** B; **10.** C.

AS — 11 : The Effects of Changes in Foreign Exchange Rates
[Effective Date : 1st April, 2009]

Introduction

Today, it is very common for enterprises to operate in more than one country. There are many multinational companies which are operating throughout the world. HP, for example, has operations in more than 100 countries. Similarly many Indian companies, for example, Reliance Industries Ltd., Tata Motors Ltd., TISCO Ltd., are operating in foreign countries. Reliance Industries Ltd. is operating in more than 10 countries like Kenya, Malaysia, Australia, UK, UAE, etc.

Again many Indian companies exports goods to foreign countries and imports goods, raw materials, plant etc., from foreign countries. All these transactions involve foreign exchange.

International business transactions have major effects on accounting. Different countries follow different currencies and majority of sales and purchases are made in local currencies. Thus local currency value needs to be converted into reporting currency value using exchange rates.

Like any commodity, the exchange rate also changes daily according to supply and demand for the currency. As a consequence, the profit of an enterprise, trading in foreign currency is influenced by the fluctuation in the exchange rate.

The main theme of this accounting standard is to prescribe for the accounting treatment of exchange difference.

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

Scope

1. This Statement should be applied :
   (a) in accounting for ***transactions*** in foreign currencies; and
   (b) in ***translating*** the financial statements of foreign operations.
2. This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.
3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement requires disclosure of the reason for using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.
4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.
5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).
6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, Borrowing Costs).

Definitions

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

Average rate is the mean of the exchange rates in force during a period.

Closing rate is the exchange rate at the balance sheet date.

Exchange difference is the difference resulting from reporting the ***same number of units of a foreign currency*** in the reporting currency at different exchange rates.

Exchange rate is the ratio for exchange of two currencies.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Foreign currency is a currency other than the reporting currency of an enterprise.

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

Forward exchange contract means an agreement to exchange different currencies at a forward rate.

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

Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Net investment in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.

Non-integral foreign operation is a foreign operation that is not an integral foreign operation.

Non-monetary items are assets and liabilities other than monetary items.

Reporting currency is the currency used in presenting the financial statements.

Foreign Currency Transactions

Initial Recognition

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

(a) buys or sells goods or services whose price is denominated in a foreign currency;
(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;
(c) becomes a party to an unperformed forward exchange contract; or
(d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

A ***foreign currency transaction*** should be recorded in the reporting currency using the exchange rate between the reporting currency and the foreign currency at the ***date of the transaction***.

The rate that should be used is the mid market rate, or 'spot' rate of the date of transaction.

An average rate may be used for a week, or a month, for all transactions in each foreign currency, if there is no significant fluctuation in the exchange rates.

The date of transaction is the date when the transaction is ***contracted*** or ***recognised***, rather than the date of receiving (or paying) cash.

Example: On 1st January, 2015 your company TCS Ltd. has raised an invoice for $ 10,000 on its USA client. The payment was received on 1st March, 2015. The exchange rate was :
1st January, 2015 — $1 = ₹ 59
1st March, 2015 — $1 = ₹ 60
It is to be recorded in the books of TCS Ltd. as follows :
1st January, 2015

Accounts Receivable Account (USA Client)	**Dr.**	**₹ 5,90,000**	
To Sales Account (₹ 59× 10,000)			**₹ 5,90,000**

1st March, 2015

Bank Account (₹ 60 × 10,000)	**Dr.**	**₹ 6,00,000**	
To Accounts Receivable Account			**₹ 5,90,000**
To Foreign Exchange Difference Account			**₹ 10,000**

Reporting at Subsequent Balance Sheet Dates

(a) ***Foreign Currency monetary*** items like money held in cash and cash equivalents, accounts receivable and accounts payable should be reported using the ***closing rate***.

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

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

Recognition of Exchange Differences

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

Net Investment in a Non-integral Foreign Operation

Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be

Example **: HPCL purchased a plant for its chemical factory on 1st January, 2015 but had not been paid for by 31st March, 2015, the date of closing the books of accounts. The cost of the plant was $ 1,00,000.**

The exchange rates were :

1st January, 2015 — $1 = ₹ 59

31st March, 2015 — $1 = ₹ 60

In the books of HPCL, it will be recorded as follows :

1st January, 2015

Plant Account (₹ 59× 1,00,000)	**Dr.**	**₹ 59,00,000**	
To Accounts Payable Account			**₹ 59,00,000**

31st March, 2015

Exchange Difference Account	**Dr.**	**₹ 1,00,000**	
To Accounts Payable Account			**₹ 1,00,000**

recognised as income or as expenses.

Illustration 1

From the following information, calculate foreign exchange gain / loss for the financial years 2011-12 and 2012-13 :

	Exchange Rate (₹)
Goods purchased on 22.1.2012 for US $ 20,000	45.80
Exchange rate on 31.3.2012	46.10
Payment made on 4.4.2013	46.30

Solution

As per AS-11 (revised), a foreign currency transaction should be recorded by applying the exchange rate between the reporting currency and the foreign currency at the ***date of the transaction***. Therefore, both purchases and creditors should be recorded at the following figure: 20,000 × ₹ 45.80 = ₹ 9,16,000.

AS-11 (revised) prescribes that all monetary items in the Balance Sheet should be reported using closing rate. Therefore, the creditors should be valued at : 20,000 × ₹ 46.10 = ₹ 9,22,000.

The exchange loss of ₹ 6,000 (₹ 9,22,000 – 9,16,000) should be debited in the Statement of Profit and Loss for the year 2011-12.

AS-11 (revised) states that exchange differences arising on the settlement of monetary items at rates different from those at which they were reported in previous financial statements should be recognised as income or loss in the period in which they arise.

In this case, though the value of the creditors is ₹ 9,22,000, they are settled at ₹ 9,26,000 (20,000 × ₹ 46.30). The exchange loss of ₹ 4,000 (₹ 9,26,000 – 9,22,000) should be debited to the Statement of Profit and Loss for the year 2012-13.

Illustration 2

How will you treat the following as per AS-11 (revised)?

(1) Debtors include amount due from X Limited, USA, fo r ₹ 6,00,000, which was recorded at $1 = ₹ 39.20 — the prevailing exchange rate on the date of sales. The exchange rate on the Balance Sheet date was $1 = ₹ 40.10.

(2) A long-term loan was obtained from Y Limited, amounting to ₹ 20,00,000, which was recorded at $1 = ₹ 36.20 — the prevailing exchange rate on the date of transaction. The exchange rate on the Balance Sheet date was $1 = ₹ 37.40.

(3) For credit purchase of plant, another loan was obtained from Z Ltd., UK for ₹ 12,00,000, which was recorded at £ = ₹ 64.10. The exchange rate on the Balance Sheet date was £ = ₹ 67.20.

Solution

AS-11 (revised) provides for the following :

(a) A foreign currency transaction should be recorded by applying the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

(b) Monetary items in the Balance Sheet should be reported using the closing rate.

(c) Exchange rate differential in respect of foreign currency deferred liability relatable to fixed assets will have to be absorbed in the Statement of Profit and Loss.

(1) Initial recognition : ₹ 6,00,000 / ₹ 39.20 = $15,306.
Rate at the Balance Sheet date : $1 = ₹ 40.10.
Debtors to be shown on the Balance Sheet date : 15,306 × ₹ 40.10 = ₹ 6,13,770.
Therefore, the exchange difference is a gain of ₹ 13,770 (₹ 6,13,770 – 6,00,000) which should be credited in the Statement of Profit and Loss.

(2) Initial recognition : ₹ 20,00,000 / ₹ 36.20 = $ 55,249.
Rate at the Balance Sheet date : $1 = ₹ 37.40.
Long-term loan to be shown on the Balance Sheet date : 55,249 × ₹ 37.40 = ₹ 20,66,312.
Therefore, the exchange difference is a loss of ₹ 66.312 (₹ 20,66,312 – 20,00,000) which should be debited in the Statement of Profit and Loss.

(3) Initial recognition : ₹ 12,00,000 / ₹ 64.10 = £ 18,721.
Rate at the Balance Sheet date : £1 = ₹ 67.20.
Long-term loan for the purchase of plant on credit to be shown on the Balance Sheet :
18,721 × ₹ 67.20 = ₹ 12,58,051.
Therefore, the exchange difference is a loss of ₹ 58,051 (₹ 12,58,051 – 12,00,000) which should be debited in the Statement of Profit and Loss.

Illustration 3

A company had imported raw materials worth US $ 6,00,000 on 5th January, 2010 when the exchange rate was ₹ 43 per US $. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2010 when the exchange rate was ₹ 47 per US$. However, on 31st March, 2010, the rate of exchange was ₹ 48 per US$. The company passed an entry on 31st

March, 2010 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US$.

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

Solution

AS—11 "The Effects of Changes in Foreign Exchange Rates", states that foreign currency monetary items should be reported using the ***closing rate***.

Exchange difference arising on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period should be recognised as income or as expenses in the period in which they arise.

(a) On 5th January, 2010 creditors were recorded for	₹ 258,00,000	(₹ 43 × 6,00,000)
(b) On 31st March, 2010 creditors were reported for	₹ 288,00,000	(₹ 48 × 6,00,000)
Loss due to exchange difference [(b) – (a)]	₹ 30,00,000	

This ₹ 30,00,000 will be charged to Profit and Loss Account for the year **2009-10** as expenses.

The accounting treatment adopted by the company was not correct **at all**.

It should be noted that in the year 2010-11 when the creditors were paid off, the exchange rate was lower than closing rate by Re 1 (₹ 48 – ₹ 47). Therefore, in 2010-11, ₹ 6,00,000 should be credited to Profit and Loss Account of 2010-11 as income.

Financial Statements of Foreign Operations

Classification of Foreign Operations

Foreign operations are classified as :

(i) Integral foreign operations; and (ii) Non-integral foreign operations.

An ***integral*** foreign operation is a dependent foreign operation or an extension of the activities of the reporting enterprise.

For example, Tata Motors Ltd. has a branch office at Dhaka, Bangladesh. This branch is exclusively selling Tata commercial vehicles and passenger cars and remits the cash immediately to Tata Motors Ltd. This is an integral foreign operation.

A ***non-integral*** foreign operation tends to act as a ***stand-alone*** unit, accumulates cash and other monetary items, incurs expenses, generate incomes and perhaps arranges borrowings, all substantially in its local currency.

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

(a) while the reporting enterprise may ***control the foreign operation***, the activities of the foreign operation are carried out with a ***significant degree of autonomy*** from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

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

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

(e) the foreign operation's sales are mainly in local currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

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

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Translation of Foreign Integral Operations

The financial statements of an integral foreign operation should be translated as if the transactions of the foreign operation had been those of the reporting enterprise itself.

The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

Translation of Foreign Non-integral Operations

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

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

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

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

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

Illustration 4

X Limited has a foreign branch in New York, USA. On 31.3.2013, the following trial balance was prepared from the books of New York office (figures in US $):

Particulars	Dr.	Cr.
Plant and machinery at cost	40,000	—
Accumulated depreciation on plant and machinery	—	26,000
Opening stock (1.4.2012)	4,000	—
Debtors and Creditors	12,000	6,000
Purchases and Sales	4,000	24,600
Cash and Bank	2,000	—
Salaries	9,000	—
Rent	2,400	—
Goods received from head office	1,000	—
Office expenses	3,600	—
Commission	—	20,000
Head Office Current Account	—	1,400
TOTAL	78,000	78,000

Additional information :

Goods sent to branch ₹ 20,000; Branch current account in the books of head office ₹ 24,000; Closing stock $625.

You are required to convert the above trial balance into ₹ assuming that the branch is (a) an integral foreign operation; and (b) a non-integral foreign operation.

The exchange rates were as under :

Opening rate $1 = ₹ 40; Closing rate $1 = ₹ 48; Average rate $1 = ₹ 44, which approximates the actual exchange rate. For plant and machinery $1 = ₹ 36.

Solution

(a) AS-11 (revised) states that in case a foreign operation is determined as an integral operation, financial statements should be translated using the same principle, as if the foreign operation had been those of the reporting entity itself. The resulting exchange gain or loss should be recognised in the Statement of Profit and Loss.

New York Branch
Trial balance as at 31.3.2013 (figures in ₹)

Particulars	Conversion Rate	Dr.	Cr.
Plant and machinery at cost	36	14,40,000	—
Accumulated depreciation on plant and machinery	36	—	9,36,000
Opening stock (1.4.2012)	40	1,60,000	—
Debtors and Creditors	48	5,76,000	2,88,000
Purchases and Sales	44	1,76,000	10,82,400
Cash and Bank	48	96,000	—
Salaries	44	3,96,000	—
Rent	44	1,05,600	—
Goods Received from Head Office		20,000	—
Office Expenses	44	1,58,400	—
Commission	44	—	8,80,000
Head Office Current Account		—	24,000
Foreign Exchange Loss (balancing figure)		82,400	—
		32,10,400	32,10,400
Closing Stock	48	30,000	

(b) AS-11 (revised) states that in case a foreign operation is determined as a non-integral operation, assets and liabilities (both monetary and non-monetary items) are to be converted by applying closing rate, but incomes and expenses are to be converted by applying average rate. The resulting exchange difference gain or loss should be accumulated in a foreign currency translation reserve.

New York Branch
Trial balance as at 31.3.2013 (figures in ₹)

Particulars	Conversion Rate	Dr.	Cr.
Plant and machinery at cost	48	19,20,000	—
Accumulated depreciation on plant and machinery	48	—	12,48,000
Opening stock (1.4.2012)	40	1,60,000	—
Debtors and Creditors	48	5,76,000	2,88,000
Purchases and Sales	44	1,76,000	10,82,400
Cash and Bank	48	96,000	—
Salaries	44	3,96,000	—
Rent	44	1,05,600	—
Goods Received from Head Office		20,000	—
Office Expenses	44	1,58,400	—
Commission	44	—	8,80,000
Head Office Current Account		—	24,000
Foreign Currency Translation Reserve (balancing figure)		—	85,600
		36,08,000	36,08,000
Closing Stock	48	30,000	—

Disposal of a Non-integral Foreign Operation

On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

Change in the Classification of a Foreign Operation

When there is a change in the classification of a foreign operation, he translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

Forward Exchange Contracts

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

Illustration 5

Sterling Ltd. purchased a plant for US $ 20,000 on 31st December, 2011 payable after 4 months. The company entered into a forward contract for 4 months @ ₹ 48.85 per dollar. On 31st December, 2011 the exchange rate was ₹ 47.50 per dollar.

How will you recognise the profit or loss on forward contract in the books of Sterling Limited for the year ended 31st March, 2012 ?

Solution **Calculation of Profit or Loss to be Recognised in books of Sterling Ltd**

Particulars		₹
Forward Contract Rate		48.85
Less: Spot Rate		47.50
Loss per Dollar		1.35
Forward contract Amount	($)	20,000
Total Loss on entering into Forward Contract (20,000 x 1.35)	(₹)	27,000
Contract Period		4 Months
Loss per month to be Amortised (27,000 ÷ 4)		6,750
In 2011-12 Loss to be recognised (3 x ₹ 6,750)	(₹)	20,250
In 2012-13 Loss to be recognised (1 x ₹ 6,750)	(₹)	6,750

Illustration 6

X Limited closes its books of account on 31st December.

On 1.9.2011, it took a forward contract cover against US $ 1,00,000. This is to be repaid on 28.2.2012. The spot rate was ₹ 46.10 and the forward rate was ₹ 46.60. What will be the treatment as per AS-11 (revised) for the accounting years 2011 and 2012 for the premium paid on the forward contract, if the exchange rate on 31.12.2011 was as follows:

(i) ₹ 46.30; (ii) ₹ 45.90; and (iii) ₹ 46.80.

Solution

The premium on the forward contract is = 1,00,000 (₹ 46.60 – 46.10)

= 1,00,000 × Re 0.50

= ₹ 50,000.

AS-11 (revised) provides for the following:

(1) The premium at the inception of a forward contract should be amortised over the tenor of the contract period.

(2) Any exchange difference on a forward contract should be recognised in the Statement of Profit and Loss at the Balance Sheet date in which the exchange rates change.

Calculation of Exchange Difference for the year ending on 31.12.2011

Particulars	Case 1 (₹)	Case 2 (₹)	Case 3 (₹)
Initial recognition (Amount x Spot Rate)	46,10,000	46,10,000	46,10,000
Value at the Balance Sheet Date (Amount x Closing Rate)	46,30,000	45,90,000	46,80,000
Exchange Difference : Profit / (Loss)	(20,000)	20,000	(70,000)

Calculation of Exchange Difference for the year ending on 31.12.2012

Particulars	Case 1 (₹)	Case 2 (₹)	Case 3 (₹)
Value at the Balance Sheet Date	46,30,000	45,90,000	46,80,000
Contracted Forward Rate Payable (Amount x forward rate)	46,60,000	46,60,000	46,60,000
Exchange Difference : Profit / (Loss)	(30,000)	(70,000)	20,000

It can be seen that the loss is ₹ 50,000 in all the above cases.

Disclosure

An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period; and

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

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

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

(a) the nature of the change in classification;

(b) the reason for the change;

(c) the impact of the change in classification on shareholders' funds; and

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

The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS–4, 'Contingencies and Events Occurring After the Balance Sheet Date'.

Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Monetary items are
   A cash only
   B cash and cash equivalent
   C money held and assets and liabilities to be received or paid in fixed or determinable amounts of money
2. Forward rate is
   A the determinable exchange rate for exchange of two currencies at a specified future date
   B the specified exchange rate for exchange of two currencies at a specified future date
   C neither of the above
3. Foreign currency is a currency
   A other than the functional currency
   B other than the reporting currency of an enterprise
   C neither of the above

4. A foreign currency transaction should be recorded in the reporting currency, using the exchange rate between the reporting currency and the foreign currency
   A at the date of settlement
   B at the last date of the month of transaction
   C at the date of transaction
5. Foreign currency monetary items should be reported using
   A the average rate for the year
   B the closing rate on the Balance Sheet date
   C the rate on the date of transaction
6. Non-monetary items should be reported using
   A the average rate for the year
   B the closing rate on the Balance Sheet date
   C the rate on the date of transaction
7. The date of transaction is
   A the date on which it is recorded in the books of account
   B the date when the transaction is contracted or recognised
   C the date of receiving (or paying) cash
8. Exchange differences arising on the settlement of monetary items should be recognised
   A in the Balance Sheet as capital reserve
   B in the Profit and Loss Account as income or expenses
   C neither of the above
9. Net investment in a non-integral foreign operation is
   A the amount invested by the reporting enterprise at cost
   B the reporting enterprises' share in the net assets of that operation
   C neither of the above
10. If the US$ falls in value against the Indian ₹ (INR), and you have net $ liability
   A an exchange loss will result
   B an exchange gain will result
   C neither gain or loss will result

PRACTICAL QUESTION

1. Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February 2012, when the exchange rate was ₹ 44 per US Dollar. the transaction was recorded in the books at the above mentioned rate. the payment for the transaction was made on 10th April, 2012, when the exchange rate was ₹ 48 per US Dollar. At the year end 31st March, 2012, the rate of exchange was ₹ 49 per US Dollar.
   The Chief Accountant of the Company passed an entry on 31st March, 2012 adjusting the cost of raw material consumed for the difference between ₹ 48 and ₹ 44 per US Dollar. Discuss whether this treatment is justified as per the priovisions of AS-11 (Revised).

Guide to Answers

1. C; **2.** B; **3.** B; **4.** C; **5.** B; **6.** C; **7.** B; **8.** B; **9.** B; **10.** B

AS — 12 : Accounting for Government Grants
[Effective Date : 1st April, 1994]

Introduction

Government is responsible for socio-economic changes. The‘se changes are effected by the government by providing financial incentives. These incentives will move society, or an economic sector, in the desired direction. Financial incentives are given in the following areas :

	Objectives	Incentives
1.	Increase Tourism	Land is given at a very cheap rate / free of cost
2.	Industrialisation	Power is provided at a cheaper rate, Tax holiday, etc.
3.	Reduce CO_2 emission	Cash subsidy for solar energy

Many organisations receive grants from state government, central government, government agencies and others. Most grants can be classified into either those which relate to revenue expenditure or those relating to capital expenditure. Government grants are generally provided directly in cash or through tax reduction.

The aim of this standard is to show the way for recognition of the government grants in the financial statements.

Objectives and Scopes

The Standard covers accounting and disclosure of government grants. These grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

This Standard ***does not*** cover :

(i) special problems arising in accounting for government grants in hyperinflationary economies;
(ii) government assistance other than in the form of government grants;
(iii) government participation in the ownership of the enterprise.

Meaning of Important Terms

Government: Government refers to the government, government agencies and similar bodies whether local, national or international.

Government Grants: Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions.

For example, to encourage the enterprise to establish hospital in small towns, local property taxes are reduced to act as an incentive.

Grants ***exclude*** those forms of government assistance which cannot reasonably have a value placed upon them and transactions with the government which cannot be distinguished from the normal trading transactions of the enterprise.

For example:

(i) Free technical assistance and marketing advice may not be easy to value and therefore will not come under the definition of government grants.

(ii) Sale to government at a minimum support price by the enterprise cannot be distinguished from enterprises normal trading transactions. Therefore, it will not come under the definition of government grants.

Grants related to specific fixed assets: Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.

Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

For example, the Delhi Government wants to encourage investment in CNG bus. It offers 25% cash subsidy for purchase of a range of buses.
The conditions are:
(i) All buses must be used in Delhi and National Capital Region (NCR).
(ii) All buses must be purchased within a 2-year period to qualify for the subsidy.

Grants related to Income/Expense: Grants related to income / expense are grants that boost income or reduce expense. For example, if the government wishes to encourage computer literacy in companies it may offer 20% reimbursement of cost of computer training courses undertaken from approved institutions.

Recognition of Government Grants in Financial Statements

General Principle

Government grants available to the enterprise are considered for inclusion in accounts:
(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and
(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

For example, an enterprise is eligible to receive a government grant for supply of pure drinking water in the whole locality and it immediately starts supplying drinking water. The grant can be recognised immediately. In this case, government grant will be accounted for on accrual basis. It should, therefore, be recorded in the books of account as 'Government Grant Receivable'.

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

Government Grants Related to Revenue and Expenses

Government grants should be recognised as income over the periods when the related costs are incurred for which the grants are intended to compensate. Such government grants should be shown in the Profit and Loss Account as 'Other Income'. Alternatively, such grants may be deducted from related expenses.

It should be noted that such grants should not be credited directly to shareholders' interest / equity.

For example, ITC Ltd. receives a grant from West Bengal Forest Development Corporation of ₹ 5,00,000 towards social forestry. The company estimates that the project will take five years to complete and expenses are to be incurred as follows:

	₹
1st year	**1,00,000**
2nd year	**1,00,000**
3rd year	**2,00,000**
4th year	**3,00,000**
5th year	**3,00,000**
Total	**₹ 10,00,000**

Grant from West Bengal Development Corporation will be recognised as income by ITC Ltd. as follows :

	₹
1st year 1/10th of ₹ 5,00,000	**50,000**
2nd year 1/10th of ₹ 5,00,000	**50,000**
3rd year 2/10th of ₹ 5,00,000	**1,00,000**
4th year 3/10th of ₹ 5,00,000	**1,50,000**
5th year 3/10th of ₹ 5,00,000	**1,50,000**
Total	**5,00,000**

***Accounting Entries** in the 1st year will be as follows :*

(i) Forestry Expenses Account	**Dr. ₹ 1,00,000**	
To Cash Account		**₹ 1,00,000**
(Being expenses incurred for social forestry project)		
(ii) Government Grant Receivable Account	**Dr. ₹ 50,000**	
To Other Income Account		**₹ 50,000**
(Being the amount receivable from West Bengal Forest Development Corporation)		

Government Grants Related to Specific Fixed Assets

There are two alternative methods for recognition of government grants for fixed assets in the books of account. These are as follows:

Method 1**:* Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a ***reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the Balance Sheet at a ***nominal value***.

***Method 2**:* Under this method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets.

However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the Balance Sheet pending its apportionment to Profit and Loss Account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g. 'Deferred government grants'.

It should be noted that both methods achieve the result of spreading the grant over the useful life of the asset; the grant either reduces the annual charge for depreciation (Method 1) or results in a credit annually to the Profit and Loss Account (Method 2).

Treatment of Government Grants at a Glance

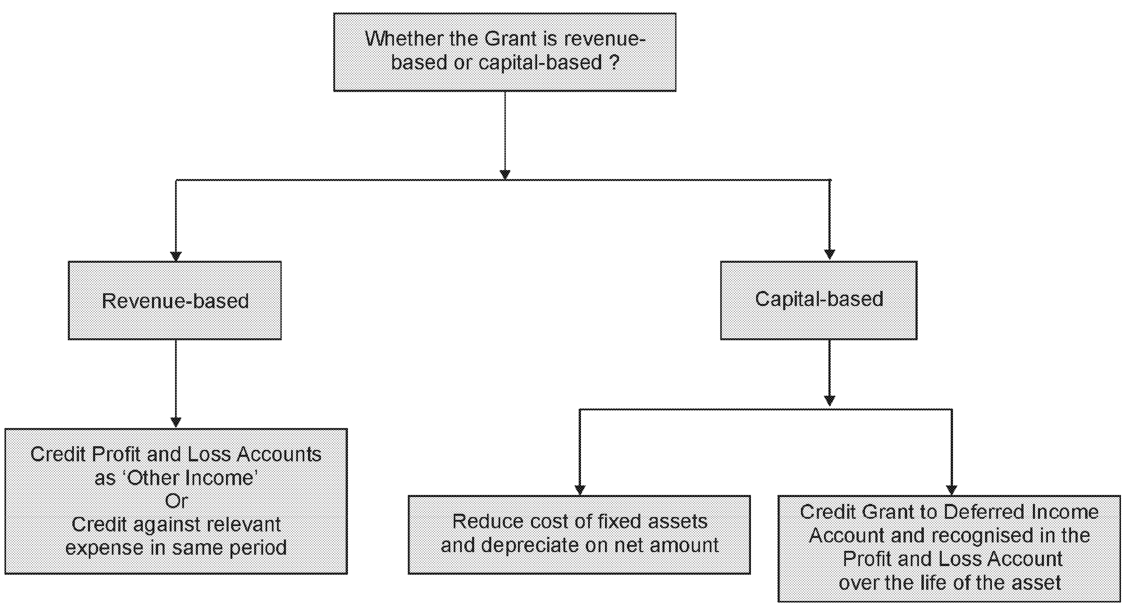


Illustration 1

On 1.1.2014, X Limited purchased machinery for ₹ 10,00,000 with an estimated life of 10 years and no residual value. A government grant of ₹ 1,50,000 was received relating to this asset one month after purchase. X Limited follows straight line method of depreciation and makes its accounts up to 31st December each year.

You are required to show the different accounting methods of treating the grant which are acceptable under AS-12 by showing the relevant :

(a) Balance Sheet figures at 31.12.2014; and (b) Profit and Loss Account figures at 31.12.2014.

Solution

Government grants related to specific fixed assets should be treated as under :

To credit the amount of the grant to Profit and Loss Account on a systematic and rational basis over the useful life of the asset by either —

(i) reducing the cost of acquisition of the fixed asset by the amount of the grant; or

(ii) treating the amount of the grant as a deferred income — a portion of which is transferred to Profit and Loss Account.

Method (i) Reduce the cost of the acquisition of the fixed asset by the amount of the grant

Balance Sheet of X Limited as at 31st December, 2014 (includes)

Liabilities	₹	₹	Assets	₹	₹
			Machinery at cost	10,00,000	
			Less: Government grant	1,50,000	
				8,50,000	
			Less: Provision for depreciation	85,000	7,65,000

Dr. Profit and Loss Account for the year ended 31st December, 2014 (includes) Cr.

Particulars	₹	Particulars	₹
To Depreciation on Machinery	85,000		

Method (ii) Treat the grant as a deferred income, a portion of which is transferred to Profit and Loss Account annually

Balance Sheet of X Limited as at 31st December, 2014 (includes)

Liabilities	₹	₹	Assets	₹	₹
Deferred Income :			Machinery at cost	10,00,000	
Government grant	1,50,000		Less: Provision for depreciation	1,00,000	*9,00,000
Less: Transfer to P&L Account	15,000	*1,35,000			

* The net effect on net assets is ₹ 7,65,000 (₹ 9,00,000 – 1,35,000) as in the first method.

Dr. Profit and Loss Account for the year ended 31st December, 2014 (includes) Cr.

Particulars	₹	Particulars	₹
To Depreciation on Machinery	**1,00,000	By Government Grant	**15,000

** The net effect is ₹ 85,000 (₹ 1,00,000 – 15,000) as in the first method.

Tutorial Note : Government grant is allocated to income over the periods and in proportion in which depreciation is charged (i.e., 1/10th).

Illustration 2

If in Illustration 1, government grant is ₹ 10,00,000, how the Balance Sheet and Profit and Loss Account would appear?

Solution

Method (i) Balance Sheet of X Limited as at 31st December, 2014 (includes)

Liabilities	₹	Assets	₹
Capital Reserve	*1	Machinery	*1

* Recorded at nominal value. (Nominal value is generally a minimal price fixed for the sake of having some consideration for a transaction, which bears no relation to the market value of the item. Generally, it is recorded at ₹ 1 to reflect the existence of the asset.).

Method (ii)

Balance Sheet of X Limited as at 31st December, 2014 (includes)

Liabilities	₹	₹	Assets	₹	₹
Deferred Income :			Machinery at cost	10,00,000	
Government Grant	10,00,000		Less: Provision for depreciation	1,00,000	9,00,000
Less: Transfer to P/L Account	1,00,000	9,00,000			

Dr. Profit and Loss Account for the year ended 31st December, 2014 (includes) Cr.

Particulars	₹	Particulars	₹
To Depreciation on Machinery	1,00,000	By Government Grant	1,00,000

Illustration 3

How will you treat the following in the Balance Sheet of a company ?

A company purchased a plot of land for ₹5,00,000 and for that it has received a government grant of ₹ 1,00,000.

Solution

It should appear in the Balance Sheet as under :

Balance Sheet as at . . . (includes)

Liabilities	₹	Assets	₹
Capital Reserve	1,00,000	Land	5,00,000

Tutorial Note : Land will be recorded as usual by debiting Land and crediting Cash. Government grant will be recorded by debiting Cash and crediting Capital Reserve.

Illustration 4

On 1.1.2012, X Limited purchased a plot of land for ₹ 10,00,000 for which a government grant of ₹ 4,00,000 was received. The condition was that the company has to construct labour quarters for the employees. The construction was completed by the end of 2012 and the cost came to ₹ 5,00,000. From the year 2013, X Limited wants to depreciate the labour quarters @ 10% p.a. under straight line method.

Show how these would appear in the Balance Sheet and Profit and Loss Account for the first 3 years (i.e., 2013 to 2015).

Solution

If a grant related to a ***non-depreciable asset*** requires the fulfillment of certain conditions, the grant should be credited to income over the period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

Balance Sheet of X Limited as at . . . (includes) (figures in ₹)

Liabilities	2013	2014	2015	Assets	2013	2014	2015
Deferred Income :				Land	10,00,000	10,00,000	10,00,000
Government Grant	4,00,000	3,60,000	3,20,000	Building (labour quarters)	5,00,000	5,00,000	5,00,000
Less: Transfer to P/Loss A/c	(40,000)	(40,000)	(40,000)	Less: Provision for Depreciation	(50,000)	(1,00,000)	(1,50,000)
	3,60,000	3,20,000	2,80,000		4,50,000	4,00,000	3,50,000

Dr. Profit and Loss Account for the year ended . . . (includes) (figures in ₹) **Cr.**

Particulars	2013	2014	2015	Particulars	2013	2014	2015
To Depreciation on Labour Quarters	50,000	50,000	50,000	By Government Grant (1/10th)	40,000	40,000	40,000

Tutorial Note : The cost of obligation to construct labour quarters is ₹ 5,00,000, which will be charged to Profit and Loss Account over 10 years, i.e., 1/10th of the cost will be charged every year. In effect, 1/10th of the government grant will be credited to Profit and Loss Account every year.

Non-monetary Government Grants

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

Illustration 5

On 1.1.2014, X Limited received a plot of land from the local government by way of government grant. The land has been encroached by local inhabitants. The condition attached to the grant is that the company has to make arrangement for the rehabilitation within a period of 2 years. The cost of rehabilitation came to ₹ 5,00,000 — ₹ 2,00,000 incurred in 2014 and the balance in 2015.

Show how these would appear in the Balance Sheet during 2014 and 2015.

Solution **Balance Sheet of X Limited as at . . . (includes)** (figures in ₹)

Liabilities	2014	2015	Assets	2014	2015
			Land	2,00,000	5,00,000

Tutorial Note : It should be noted that cost of the land, though received free of cost, comes to ₹ 5,00,000 — the cost of rehabilitation. The only journal entry that will be passed is :

Land Account Dr.

To Cash Account

Grants of the Nature of Promoters' Contribution

Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Government Grants — Special Cases

1. In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an intensive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate.

For example, National Textile Corporation (NTC) is in deep financial trouble, but the Central Government provides cash grants of ₹ 5,00,000 to help NTC to continue business. NTC will recognise the grant in full as income, and disclose the same as an extraordinary item.

2. Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate.

For example, MMTC suffered an export loss in the year 2012-13. After prolonged negotiation, the Central Government pays ₹ 2,00,000 as compensation in April 2013.

The grant of ₹ 2,00,000 will be recognised by MMTC Ltd. for the year 2012-13 as income and will disclose it as an extraordinary item.

Repayment of Government Grants

Sometimes for non-compliance of terms and conditions, a government grant becomes repayable partly or in full. Such grant may be :

(i) related to revenue and expenses; or
(ii) related to a specific fixed assets; or
(iii) in the nature of promoters' contribution.

Grant Related to Revenue and Expenses

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

Illustration 6

During 2011-12, Dabur India Ltd. received ₹ 2 crores as government grant for staff recruitment from minority community over 2 years. During 2014-15, the entire amount of government grant become refundable for non-compliance of certain conditions. The unamortised deferred credit appears in the books is ₹ 1.50 crores. How will you treat this refund in the accounts of Dabur India Ltd. ?

Solution

The company so far have recognised ₹ 50 lakhs as income in the Profit and Loss Account. In this case, government grant refundable is ₹ 2 crores. Unamortised deferred credit of ₹ 1.50 crores. The balance of ₹ 50 lakhs is to be debited to Profit and Loss Account.

Illustration 7

Siva Limited received a grant of ₹ 1,500 lakhs during the last accounting year (2009-10) from Government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2010-11, it was found that the conditions of the grant were not compiled with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment with reference to the provisions of AS-12. ***[C.A. (IPCC) — May, 2012]***

Solution

As per para 11 of AS-12 'Government Grants', a grant that become refundable should be treated as an extraordinary item as per As-5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.'

The refund of revenue grant is adjusted 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 to Profit and Loss Account. Therefore, the refund of ₹ 1,500 lakhs should be shown in the Profit and Loss Account as ***extraordinary*** item.

Grants Related to a Specific Fixed Assets

The amount refundable in respect of a government grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is ***increased***, depreciation on the revised book value is provided ***prospectively*** over the residual useful life of the asset.

Illustration 8

During 2011-12, X Limited purchased a machinery for ₹ 10,00,000 against which it had received a government grant of ₹ 2,00,000. The useful life of the machine is 8 years with no scrap value. During 2014-15, the grant had become refundable owing to non-fulfillment of required conditions. How will you treat this in the books of accounts ?

Solution

The amount refundable in respect of a grant related to a specific fixed asset should be recorded either by —

1. increasing the book value of the asset by the amount refundable. The depreciation on the revised book value should be provided *prospectively* over the remaining useful life of the asset;

OR

2. reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable.

Alternative 1

If the grant of ₹ 2,00,000 has been deducted from the cost of the asset, it should be added back to the W.D.V. of the asset, i.e., ₹ 5,00,000 (cost *minus* depreciation for 3 years @ ₹ 1,00,000 p.a.) + ₹ 2,00,000 = ₹ 7,00,000.

The revised book value is ₹ 7,00,000 and remaining useful life is 5 years. Therefore, the annual depreciation will be ₹ 1,40,000 from the year 2014-15.

Alternative 2

If the grant of ₹ 2,00,000 has been recognised as deferred income, the balance of this account should be eliminated from the books.

Illustration 9

X Ltd. received a grant of ₹ 2 crores from the Central Government for the purchase of a special machinery during 1998-99. The cost of machinery was ₹ 20 crores and had a useful life of 9 years. During 2002-03, the grant has become refundable due to non-fulfillment of certain conditions attached to it. Assuming the entire grant was deducted from the cost of machinery in the year of acquisition, state with reasons the accounting treatment to be followed in the year 2002-03. ***[C.A. (PE-II) — May, 2004]***

Solution

As per para 21 of AS—12, 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 life of the asset.

Here, in this case, the calculation is made as under (figures in crores) :

Cost of special machinery	20
Less: Central Government grant received	2
Net cost of the machinery to be depreciated	18
Depreciation per year as per straight line method (assumed) 18/9 = 2.	
Total depreciation from 1998-99 to 2001-02	$2 \times 4 = 8$
Book value in the year 2002-03 (18 – 8)	10
Add: Central Government grant to be refunded	2
Revised book value	12

Therefore, annual depreciation $= \dfrac{\text{Revised book value}}{\text{Remaining useful life}} = \dfrac{12}{5} = \mathbf{2.4}$ crores

Illustration 10

On 1.4.2010, X Limited purchased an equipment for ₹ 20,00,000 with an estimated life of 10 years and no residual value. A government grant of ₹ 10,00,000 was received relating to this asset. The company reduced the cost of the acquisition of the equipment by the amount of the grant and started providing depreciation under straight line method. During 2014-15, after a protracted legal battle, it has been decided that the company has failed to fulfill the required conditions attached to the grant. Accordingly, the grant was refunded in full.

Pass necessary journal entries and show ledger accounts.

Solution

When the cost of the acquisition of an asset is reduced by the amount of the grant and the amount refundable in respect of that should be recorded by increasing the book value of the asset by the amount refundable.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2014-15	Equipment A/c	Dr.		10,00,000	
?	To Government Grant Refund A/c				10,00,000
	(Being the government grant refundable owing to non-fulfillment of required conditions)				
?	Government Grant Refund A/c	Dr.		10,00,000	
	To Bank A/c				10,00,000
	(Being the government grant refunded)				

Ledger

Dr. Equipment Account (At Cost) Cr.

Date	Particulars	L.F.	₹	Date	Particulars	L.F.	₹
2014				2015			
April 1	To Balance b/d		10,00,000	Mar 31	By Balance c/d		20,00,000
?	To Government Grant Refund A/c		10,00,000				
			20,00,000				20,00,000

Dr. **Provision for Depreciation Account** **Cr.**

Date	Particulars	L.F.	₹	Date	Particulars	L.F.	₹
2015 Mar 31	To Balance c/d		6,67,000	2014 April 1	By Balance b/d		4,00,000
				2015 Mar 31	By Depreciation A/c		*2,67,000
			6,67,000				6,67,000

*Till 31.3.2014, the company provided depreciation of ₹ 4,00,000. Now from 1.4.2014 the W.D.V. of the asset becomes ₹ 6,00,000 (₹ 10,00,000 – 4,00,000 depreciation) + ₹ 10,00,000 = ₹ 16,00,000. The depreciation on the revised book value should be provided *prospectively* over the remaining useful life of the asset. Therefore, the annual depreciation is : ₹ 16,00,000 / 6 (10 – 4) = ₹ 2,67,000 (approx.)

Illustration 11

A University receives two grants — one from the Ministry of Human Resources to be used for Aids Research. The grant is for ₹ 45,00,000 which includes ₹ 3,00,000 to cover indirect expenses incurred in administering the grant. The second grant of ₹ 35,00,000 received from a reputed Trust is to be used to set up a centre to conduct seminars on Aids related matters from time to time. During the year, it also received ₹ 5,00,000 worth of equipments donated by a well wisher to be used for Aids research. During the year 2013-14, the University spent ₹ 32,25,000 of the government grant and incurred ₹ 3,00,000 overhead expenses. ₹ 28,00,000 were spent from the grant received from the Trust. Show the necessary journal entries.

Solution **Journal** **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
	Bank A/c Dr. To Government Grant A/c (Being government grant received from Ministry of Human Resources)		45,00,000	 45,00,000
	Bank A/c Dr. To Grant from Trust A/c (Being government grant received from a Trust)		35,00,000	 35,00,000
	Equipments A/c Dr. To Capital Reserve A/c (Being equipments received in the nature of a grant, recorded at nominal value*)		1	 1
	Expenses A/c Dr. To Bank A/c (Being the expenses incurred from government grant)		35,25,000	 35,25,000
	Centre for Seminars A/c Dr. To Bank A/c (Being the cost incurred from grant received from the Trust)		28,00,000	 28,00,000
	Government Grant A/c Dr. To Profit and Loss A/c (Being the expenses incurred from government grant transferred to Profit and Loss Account)		35,25,000	 35,25,000
	Grant from Trust A/c Dr. To Profit and Loss A/c (Being an equal amount of depreciation charged on Centre for seminar transferred to Profit & Loss Account)		?	 ?

*Nominal value is generally a minimal price fixed for the sake of having some consideration for a transaction, which bears no relation to the market value of the item. Generally, it is recorded at ₹ 1 to reflect the existence of the asset.

Tutorial Note : According to "Technical Guide on Accounting and Auditing in Not-for-profit organisations" NPOs are expected to follow AS-12. Therefore, the following points should be remembered:

(a) Donations and grants should not be recognised until there is reasonable assurance that the —
(i) NPO will comply with the conditions attached to them; and
(ii) ultimate collection of donations and grants will be made.

(b) In the case of donated fixed assets, no depreciation is required to be provided since the assets are treated to be recorded at nominal value.

Grants in the Nature of Promoters' Contribution

Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Disclosure

The following should be disclosed:

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

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

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. AS — 12 deals with
   A government participation in the ownership of the enterprise
   B special problems arising in accounting for government grant in hyper inflationary economies
   C disclosure of government grants
2. Government grant includes
   A free technical assistance
   B indirect help, such as improving local road
   C duty drawbacks
3. Government grants may be related to
   1. Specific Fixed Assets
   2. Revenues
   3. Expenses
   Which of the following alternative is correct ?
   A 1 and 3
   B 1, 2 and 3
   C 1 only
4. On the notification that an enterprise will receive a government grant
   A enterprise will do nothing until the cash is received
   B enterprise will record it on an accrual basis
   C enterprise will open an 'Account Receivable', but the grant will be recorded after cash is received
5. Where the government grants are of the nature of promoters' contribution and no repayment is ordinarily expected thereof, the grant is treated as
   A capital reserve which can be distributed as dividend because it has been received in cash
   B capital reserve which cannot be distributed as dividend
   C deferred income
6. When the government grant is in the form of land at no cost, then it should
   A not be recorded at all
   B be recorded at a fair value
   C be recorded at a nominal value
7. When a government grant is awarded for the purpose of giving immediate financial support to an enterprise
   A it should be transferred to capital reserve
   B it should be credited to Profit and Loss Account of the period in which the enterprise qualifies to receive it
   C one-half is to be recognised in the current period while the other half is to be recognised in the next period.

8. The amount refundable in respect of a grant related to revenue should be applied
   A first against capital profit
   B first against current profit
   C first against unamortised deferred credit
9. The amount refundable in respect of a grant related to a specific fixed asset should be recorded
   A by reducing general reserve
   B by increasing the book value of the asset
   C by reducing the book value of the asset
10. Government grant in the nature of promoters' contribution that become refundable
   A should be reduced from the general reserve
   B nshould be reduced from the capital reserve
   C should be charged to current year's profit

PRACTICAL QUESTIONS

1. Santosh Ltd has received a grant of ₹ 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed ₹ 2 crores as dividend. Also, Santosh Ltd received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent. In the light of AS-12 examine, whether the treatment of both the grants is correct.
   [C.A. (IPCC) — Adapted]
2. X Ltd received a revenue grant of ₹ 10 crores during 2011-12 from Government for welfare activities to be carried on by the company for its employees. The grant prescribed the conditions for utilization. However, during the year 2013-14, it was found that the prescribed conditions were not fulfilled and the grant should be refunded to the Government,.
   State how this matter will have to be dealt with in the financial statements of X Ltd for the year ended 2013-14. ***[C.A. (IPCC) — Adapted]***

Guide to Answer

Multiple choice

1. C; **2.** C; **3.** B; **4.** B; **5.** B; **6.** C; **7.** B; **8.** C; **9.** B; **10.** B

Practical Questions

1. (i) Government grant received for setting up a factory is not available for distribution as dividend.
   (ii) The land should be recorded in the books of account at a nominal value.
   Therefore, the treatment of both the grants is incorrect as per AS-12.
2. Refund of grant of ₹ 10 crores should be shown in the Profit and Loss Account of the company as an ***extraordinary*** item during the financial year 2013-14.

AS—13 : Accounting for Investments
[Effective Date : 1st April, 1995]

Introduction

Most companies are holding investments for different reasons. One reason, of course, is simple : earning income by way of dividends, interest and rentals. Another might be for capital appreciation or for other benefits to the investing enterprise (e.g., assured supply of raw materials at a concessional rate).

In many cases, investment activity is a major source of income of the enterprise. The financial performance of these enterprises solely or largely depend upon the reported results of this activity.

This statement deals with accounting for investments in the financial statements of enterprise and related conditions of disclosure.

Scope

This Statement does not deal with:

(a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard–9 on Revenue Recognition;

(b) operating or finance leases;

(c) investments of retirement benefit plans and life insurance enterprises; and

(d) mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

Definitions

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

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

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

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

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

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

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

Classification of Investments

An enterprise should disclose current investments and long term investments distinctly in its financial statements.

Further classification of current and long-term investments should be as specified in the statute governing the enterprise.

For example, Banks are required to classify investments in the following categories as per RBI guideline :

(a) Investments held to maturity

(b) Investments held for trading

(c) Available for sale investments.

In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

(a) Government or Trust securities
(b) Shares, debentures or bonds
(c) Investment properties
(d) Others—specifying nature.

Cost of Investments

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

For example, X Limited purchased 10,000 shares @ ₹ 120 each and paid brokerage @ 2%.

The acquisition cost of the investment is as under :	₹
Cost of shares (10,000 × ₹ 120)	1,20,000
Add : Brokerage (2% on ₹ 1,20,000)	2,400
Cost of acquisition	1,22,400

If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be ***the fair market value of the securities issued*** (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

For example, X Limited acquired 10,000 shares of ₹ 100 each (market value ₹ 130 each) in Y Ltd. by the issue of its 10,000 shares — face value and market value per share being ₹ 100 and ₹ 120 respectively. To ascertain the cost of the investment, in such a case, market value of the shares issued is to be considered. Therefore, the value of the investment is 10,000 × ₹ 120 = ₹ 1,20,000.

If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value (market value or net realisable value) of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

For example, X Limited acquired 10,000 shares of ₹ 100 each (market value ₹ 120 each) in exchange for a machinery (W.D.V. ₹ 90,000 and market value ₹ 1,10,000). The cost of the investment in this case, would be either the fair value of the shares acquired, i.e., ₹ 1,20,000 or the fair value of the machiney given up, i.e., ₹ 1,10,000 — which is more clearly evident.

Pre-acquisition Interest, Dividends and Rentals

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

For example, On 1st April, 2015 X Ltd. purchased 2000, 12% debentures of ₹ 100 each @ ₹ 98 (cum-interest). Debenture interest is payable half-yearly on 30th June and 31st December. Date of closing the books of account is 31st December every year. Cost and accrued interest are to be calculated as follows:

Step 1 **: Calculation of period (in months) — From 1.1.2013 to 31.3.2013 = 3 months.**

Step 2 **: Accrued interest = 12% × 3/12 × s 2,00,000 = ₹ 6,000.**

Step 3 **: Cost] (₹ 98 × 2,000)** ***less*** **₹ 6,000 = ₹ 1,96,000 – ₹ 6,000 = ₹ 1,90,000.**

When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

Rights Share

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

Example 1 : X Limited purchased 10,000 shares of ₹ 10 each at ₹ 25 per share of Y Limited during 2009-10. During 2013-14, Y Ltd offered rights issue at one share for every two held at a price of ₹ 20 per share. If X Limited subscribes to the rights issue, the carrying cost of the investment will be as under :

	₹
Cost of original holding (10,000 × ₹ 25)	**2,50,000**
Cost of rights issue (5,000 × ₹ 20)	**1,00,000**
Carrying cost of Investments	**3,50,000**

Example 2 : X Limited purchased 1,000 shares (cum-rights) of ₹ 10 each at ₹ 15 per share of Y Limited and paid ₹ 500 as brokerage. Y Limited offered rights issue at one share for ₹ 12 for every two held. X Limited sold the rights in the market and realised ₹ 1,000. After the rights issue was subscribed, the market value of share fell down from ₹ 15 to ₹ 14.50 per share. In such a case, the decline in the market value amounting to ₹ 500 [1,000 × (₹ 15 – ₹ 14.50)] should be adjusted against cost of investment and the balance of ₹ 500 is to be treated as income and it is to be credited to Profit and Loss Account.

Investment Properties

An enterprise holding investment properties should account for them as long term investments.

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

Example: X Ltd. purchased a flat from a co-operative society for ₹ 50,00,000. It will be rented out to other company to obtain the membership of the society. X Ltd. had to purchase 1,000 shares of ₹ 100 each of the society.
The cost of acquisition of this investment property becomes ₹ 50,00,000 + ₹ 1,00,000 = ₹ 51,00,000.

Carrying Amount of Investments

Current Investments

Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

Long term Investments

Investments classified as long term investments should be carried in the financial statements ***at cost***. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Investment Property

As per AS—13: Investment Property is treated as long-term investment. However, it is carried in the financial statements ***not at cost but at cost less accumulated depreciation and accumulated impairment loss***. It is done because the Companies Act, 1956 requires that depreciation should be claimed on all depreciable fixed assets including investment property (building).

Change in the Carrying Amounts of Investments

Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the Profit and Loss Account.

Disposal of Investments

When an investment is sold, the difference between the carrying amount and the disposal proceeds, net of expenses, should be charged or credited to the Profit and Loss Account. When disposing of a part of the holding of an individual investment, the carrying amount is to be allocated to that part is to be determined on the basis of the ***average carrying amount of the total holding of the investment***.

Reclassification of Investments

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

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the Profit and Loss Account.

Disclosure

The following information should be disclosed in the financial statements:

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

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. AS—13 : Accounting for Investments deals with
   A operating leases only
   B financial lease only
   C neither operating lease nor finance lease
2. A long-term investment is an investment other than
   A investment properties
   B a current investment
   C none of the above

3. Pre-acquisition interest on investment is
   A credited to profit and loss account
   B credited to capital reserve
   C deducted from the total cost of acquisition
4. A provision for diminition in the value of a long-term investment should be made when the decline is believed to be
   A temporary
   B permanent
   C neither of the above
5. When rights shares offered are subscribed for, the cost of rights shares are
   A accounted for separately
   B added to the carrying amount of the original holding
   C deducted from the carrying amount of the original holding
6. An enterprise holding investment properties should account for them as
   A current investments
   B separate asset
   C long-term investments
7. Investment properties (e.g., buildings) are carried in the financial statements
   A at cost
   B at fair market value
   C at cost less accumulated depreciation and accumulated impairment loss
8. Any reduction in carrying amount and any reversals of such reductions should be adjusted in
   A the revaluation reserve
   B the general reserve
   C the profit and loss account
9. Profits on disposal of investment is
   A credited to revaluation reserve
   B credited to profit and loss account
   C credited to investment fluctuation fund
10. When investments are re-classified from current to long-term, the transfers are made at
   A cost
   B the lower of cost and fair value on the date of transfer
   C fair value on the date of transfer

Guide to Answers

1. C; **2.** B; **3.** C; **4.** B; **5.** B; **6.** C; **7.** C; **8.** C; **9.** B; **10.** B

AS—14 : Accounting for Amalgamation
[Effective Date : 1st April, 1995]

Introduction

Companies have always tried to grow through the development of new products and expansion of existing products in the new potential markets. In many cases, however, the desired growth can be achieved through amalgamation (merger and acquisition).

There are generally three common ways in which companies can amalgamate together to gain advantage in their market. They are as under :

Horizontal It is an amalgamation that takes place between two companies in the same line of business. For example, when a tea company amalgamates with another tea company. The main purpose of horizontal amalgamation is the acquisition of a competitor, by either companies, in the same line of business, which increases the market share and reduce competition in one stroke.

Vertical It is an amalgamation that takes place when a company amalgamates with a supplier or a customer. Both strengthen the amalgamated company's competitive position and may enable it to diversify.

Conglomerate Conglomerate is a diversified group of companies. In a conglomerate amalgamation, the amalgamating companies are in totally unrelated lines of business. The main purpose of conglomeration is diversification of risks.

The main motives for amalgamation are :

(i) achieving economies of scale;
(ii) encouraging diversification;
(iii) rapidity in market entry;
(iv) enhancing operating efficiency;
(v) acquiring technology, marketing channels etc.
(vi) management effectiveness can be availed of through superior management talent.

Scope

This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

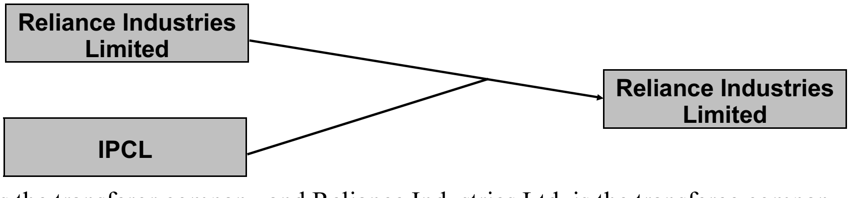
This statement does not deal with the ***acquisition of whole or part of the shares*** or whole or part of the assets of another company. The distinguishing feature of an acquisition is that the acquired company is not dissolved.

Definitions

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

(a) ***Amalgamation*** means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.
(b) ***Transferor company*** means the company which is amalgamated into another company.
(c) ***Transferree company*** means the company into which a transferor company is amalgamated.

Example:



Here, IPCL is the transferor company and Reliance Industries Ltd. is the transferee company.

(d) ***Reserve*** means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

(e) A***malgamation in the nature of merger*** is an amalgamation which satisfies ***all*** the following conditions.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of ***equity shares*** in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

(f) ***Amalgamation in the nature of purchase*** is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.

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

(h) ***Fair value*** is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

(i) ***Pooling of interests*** is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.

Types of Amalgamation

An amalgamation may be either —

(a) an amalgamation in the nature of merger, or

(b) an amalgamation in the nature of purchase.

If ***all*** the ***five*** conditions stated in paragraph (e) of definitions are satisfied then it will be treated as an amalgamation in the ***nature of merger***.

If one of the five conditions is not satisfied, it will be treated as amalgamation in the ***nature of purchase***.

Methods of Accounting for Amalgamations

There are two methods of accounting for amalgamations :

(i) the Pooling of Interest Method

(ii) the Purchase Method

It should be noted that the accounting standard deals with the accounting procedures only in the books of the transferee company.

When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for under the pooling of interests method.

When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method.

The Pooling of Interests Method

In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. 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 the General Reserve, if any.

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS) 5 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.

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.

Example : On 31st March, 2014, Weak Ltd. was absorbed by Strong Ltd., the latter taking over all the assets and liabilities at book values. The consideration was fixed at ₹ 3,00,000 to be discharged by Strong Ltd. in the form of 25,000 equity shares of ₹ 10 each fully paid and cash of ₹ 50,000. Each shareholder of Weak Ltd. will get one share of Strong Ltd.

This is an amalgamation in the nature of merger because :

- **(i) All assets and liabilities have been taken over by Strong Ltd. at book value.**
- **(ii) All equity shareholders of Weak Ltd. will become the shareholders of Strong Ltd.**
- **(iii) Purchase consideration has been discharged by issue of equity shares of Strong Ltd.**
- **(iv) It is assumed that the business of Weak Ltd. is intended to be carried on.**
- **(v) It is assumed that no adjustment is intended to be made to the book value of the assets and liabilities of Weak Ltd. when they are incorporated in the financial statement of Strong Ltd.**

As it is an amalgamation in the nature of merger, the 'pooling of interest method' is to be adopted in accounting for the amalgamation. The 'amount to be adjusted in general reserve is calculated as follows :

Share Capital issued by Strong Ltd. (25,000 × ₹ 10)	**2,50,000**
Add: Cash paid	**50,000**
Purchase consideration agreed upon	**3,00,000**
Less: Share capital of Weak Ltd. (Shareholders of Weak Ltd. will get one share of Strong Ltd. for each share of Weak Ltd.)	**2,50,000**
Amount to be adjusted in the general reserve	**50,000**

The Purchase Method

In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company.

Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as ***goodwill*** arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as ***Capital Reserve***.

The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed ***five years*** unless a somewhat longer period can be justified.

Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Common Procedures

The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable.

Example : X Ltd. acquired Y Ltd. for ₹ 60 crores. X Ltd. will pay an additional ₹ 5 crores, if the profits of the coming year is more than last year's profit.

This will be an adjustment to the consideration, which is contingent on future events. If it is probable that the target will be achieved the amount of additional payment should be included in the consideration, at the acquisition date.

Treatment of Reserves Specified in a Scheme of Amalgamation

Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Where the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Statement that would have been followed had no treatment been prescribed by the scheme, the following disclosures should be made in the first financial statements following the amalgamation:

(a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Statement.

(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Statement that would have been followed had no treatment been prescribed by the scheme.

(c) The financial effect, if any, arising due to such deviation.

Disclosure

For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the ***pooling of interests method***, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the ***purchase method***, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Amalgamation Adjustment Account is used for recording
   A capital reserve in the books of the transferee company
   B general reserve in the books of the transferee company
   C statutory reserve in the books of the transferee company.
2. Investment Allowance Reserve is a
   A capital reserve
   B statutory reserve
   C none of A or B.
3. For calculating purchase consideration as per AS—14,
   A only payment to equity shareholders are to be taken into consideration
   B only payment to shareholders are to be taken into consideration
   C payments to shareholders as well as debentureholders are to be taken into consideration.
4. Under pooling of interests method, all costs associated with the amalgamation are
   A capitalised
   B expended as incurred
   C none of the above.
5. In an amalgamation in the nature of merger
   A all assets and liabilities are taken over by the transferee company at agreed value
   B all assets and liabilities are taken over by the transferee company at book value
   C none of the above.

Guide to Answer

1. C; **2.** B; **3.** B; **4.** B; **5.** B

AS — 16 : Borrowing Costs
[Effective Date : 1st April, 2000]

Introduction

Companies require funds for two purposes — (i) for investment in long term assets (like plant, machinery, properties, furniture, etc.) and (ii) for working capital. The requirement of funds is more acute at the time of expansion.

For established companies majority portion of these funds are coming from internal accruals (retained earnings and depreciation). In most of the cases there is a gap between the cash that the companies need and the cash that they generate internally. To make up this gap, companies issue shares to the public / other investors or borrow from banks, financial institutions, investment bankers. Sometime companies issue debentures also.

When funds are borrowed, certain costs are incurred. It may include :

(i) Interest and commitment charges
(ii) Discount or premiums relating to issue of debentures, bonds etc.
(iii) Other incidental expenses, e.g., legal expenses, brokerages, stamp duty, etc.

The objectives of this statement is to prescribe the accounting treatment for borrowing costs.

Scope

1. This Statement should be applied in accounting for borrowing costs.
2. This Statement does not deal with ***the actual or imputed cost of owners' equity***, including preference share capital not classified as a liability.

Definitions

Borrowing Costs

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

Borrowing costs may include:

(a) interest and ***commitment charges on bank borrowings*** and other short-term and long-term borrowings.

Example : Your company HCC Ltd. is constructing a cricket stadium (a qualifying asset). For this purpose, your company has purchased a "Volvo" crane for ₹ 1 crore. It was financed through bank borrowing @ 12% p.a. The amount is to be paid in 60 equal monthly installments. Bank will also charge ₹ 50,000 as "commitment charge" if your company fails to pay any installment.
Here, the interest element in installment and commitment charges, if any, will be included in the borrowing costs.

(b) amortisation of discounts or premiums relating to borrowings.

Example : R.P. Ltd. issues 5,00,000, 12% debentures of ₹ 100 each at discount of 5%, redeemable at the end of 5 years at a premium of 5%. The money will be required for construction of a new plant (a qualifying asset).
Here, discount is ₹ 25,00,000 (5,00,000 × ₹ 5) and premium is also ₹ 25,00,000. This total ₹ 50,00,000 will be included in the borrowing costs.

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings.

Example : Let us assume that the issue of debentures in the above example was managed by Karvy Securities Ltd. and their charge was 1% of the face value of the debentures issued.
Here, ₹ 5,00,000 will be included in the borrowing costs as issue expenses.

(d) finance charges in respect of assets acquired under finance leases or under other similar arrangements.

Example : Your company Modern Chemical Ltd. has purchased 10 heavy duty trucks on finance lease from Magma Finance Ltd. All the trucks will be used for the whole year for construction of the chemical factory (a qualifying asset) at Haldia, West Bengal.
The company will pay ₹ 15,00,000 per month as installment. Accounting for finance lease (Para 18 of AS—19) involves splitting the installment between depreciation and finance expenses. The finance expenses will be included as borrowing costs.

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

Accounting Standard Interpretation 10 states that the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the principal of the foreign currency borrowings, the entire amount of exchange difference is regarded as an adjustment to interest costs.

Example : T.S. Ltd. has taken a foreign currency loan of £ 1,00,000 on 1st January, 2012 for its new project. The rate of interest is 5% p.a. and exchange rate on that date was £ 1 = ₹ 75.
The same loan could have been borrowed by the company in local currency @ 15% p.a. The exchange rate on 31st December, 2012 was £ 1 = ₹ 80.

Calculation of Borrowing Costs

	₹
1. Interest on local currency loan [1,00,000 × ₹ 75 × 15%]	11,25,000
2. Interest on foreign currency loan [1,00,000 × ₹ 75 × 5%]	3,75,000
3. Difference between interest on local currency and Interest on foreign currency borrowings	7,50,000
Difference in exchange (increase in liability) [1,00,000 × (₹ 80 – ₹ 75)]	**₹ 5,00,000**

Difference between interest on local currency and interest on foreign currency borrowing is more than the exchange difference loss (increase in liability). Therefore, ₹ 5,00,000 increase in liability towards principal amount is regarded as an adjustment to the borrowing cost. So, the total borrowing cost = ₹ 3,75,000 + ₹ 5,00,000 = ₹ ***8,75,000***.

In the above ***Illustration***, if the interest rate on local currency borrowings is assumed to be 11% in place of 15% then the calculation of borrowing cost will be as follows :

	₹
1. Interest on local currency loan [1,00,000 × ₹ 75 × 11%]	8,25,000
2. Interest on foreign currency loan [1,00,000 × ₹ 75 × 5%]	3,75,000
3. Difference between interest on local currency and interest on foreign currency borrowings	4,50,000
Difference in exchange (increase in liability) [1,00,000 × (₹ 80 – ₹ 75)]	**₹ 5,00,000**

Therefore, out of ₹ 5,00,000, only ₹ 4,50,000 will be considered as the borrowing cost. Thus total borrowing cost would be ₹ **8,25,000** (₹ 3,75,000 interest on foreign currency borrowings + ₹ 4,50,000 difference of interest).

Illustration 1

Sun Co-operative Society Ltd has borrowed a sum of US $ 12.50 million at the commencement of the financial year 2011-12 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, 2012 is ₹ 48 to the US dollar. Had Sun Co-operative Society Ltd borrowed the ₹ 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. ***[C.A. (Final) — May, 2012]***

Solution

Computation of Borrowing Cost as per AS-16 and Computation of Exchange Difference as per AS-11.

1. Interest for the period 2011-12 = [$ 12.5 million × ₹ 48 × 5%] = ₹ 30 million
2. Interest on Indian Currency Loan = [$ 12.5 million × ₹ 45 × 11%] = ₹ 61.875 million
3. Difference between interest on Indian currency and on foreign currency = [₹ 61.875 – 30] = ₹ 31.875 million
4. Difference in exchange (increase in liability) = [$ 12.5 million × (48 – 45)] = ₹ 37.50 million.

The difference in exchange (₹ 37.50 million) is more than the difference in interest (₹ 31.875). Therefore, the excess of ₹ 5.625 million will be accounted for as per AS-11 '***The Effects of Changes in Foreign Exchange Rate***'.

₹ 61.875 million (₹ 30 million for interest on foreign currency + interest difference of ₹ 31.875) will be treated as borrowing cost and will be accounted for as per AS-16 '***Borrowing Costs***'.

Qualifying Asset

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

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

Example 1 : Reliance Petroleums Ltd. is putting up a refinery at Jamnagar, Gujarat. The construction was started few years back. It is expected that it will be ready for commercial use in October, 2013. This is a qualifying asset for Reliance Petroleums Ltd.

Example 2 : Your company United Breweries Ltd. is making high quality wine. It must be allowed 12 years to mature. The inventory of wine is a qualifying asset.

Example 3 : Manufacturing of apple juice takes only few days. It is not a qualifying asset.

Accounting Standard interpretation 1 states that the issue as to what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of 12 months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get ready for its intended use or sale should be considered.

Accounting Treatment of Borrowing Costs

There are two options for the accounting treatment of borrowings costs :

1. Capitalisation
2. Treat it as an expense

Borrowing costs that are directly attributable to the acquisition, construction or production of a ***qualifying asset*** should be ***capitalised as part of the cost of that asset***.

Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in ***future economic benefits*** to the enterprise and the costs can be ***measured reliably***.

Borrowing Costs Eligible for Capitalisation

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

Example : Your company HPCL is building a chemical plant. The company has issued 12% Debentures of ₹ 100 crores for this purpose. The funds are exclusively used in the construction of the chemical plant. Annual interest costs are ₹ 1.2 crores. This interest costs should be capitalised as part of the cost of the plant.

Illustration 2

The notes to accounts of X Ltd for the year 2014-15 include the following:

"Interest on bridge loan from banks and financial institutions and on debentures specifically obtained for the company's fertiliser project amount to ₹ 1,80,80,000 has been capitalised during the year, which includes approximately ₹ 1,70,33,465 capitalised in respect of the utilisation of loan and debenture money for the said purpose."

Is the treatment correct? Briefly comment.

Solution

As per para 6 of AS-16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Here, in this case, only ₹ 1,70,33,456 should have been capitalised. The balance of ₹ 10,46,535 should have been treated as an expense in the statement of profit and loss. Hence, the ***treatment is not correct***.

Illustration 3

On 20.4.2015, JLC Ltd. obtained a loan from the bank for ₹ 50 lakhs to be utilised as under :

Construction of a shed — ₹ 20 lakhs; Purchase of machinery — ₹ 15 lakhs; Working capital — ₹ 10 lakhs; and Advance for purchase of truck — ₹ 5 lakhs.

On March 2015, construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2014 was ₹ 9 lakhs. Show the treatment of interest under AS—16.

Solution

As per para 3 of AS—16, a **qualifying asset** is an asset that necessarily takes a substantial period of time (a period of 12 months) to get ready for its intended use or sale.

As per para 5 of AS—16, assets that are ready for their intended use or sale when acquired are not qualifying asset.

As per 6 of AS—16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of the asset.

Statement Showing Interest to be Capitalised or Charged to Revenue (figures in Lakhs)

Amount spent on	Qualifying asset or not	Interest to be capitalised	Interest to be charged to Profit and Loss Account
Construction of a shed	Yes	$9 \times \frac{20}{50} = 3.60$	
Purchase of machinery	No		$9 \times \frac{15}{50} = 2.70$
Working capital	No		$9 \times \frac{10}{50} = 1.80$
Advance for purchase of truck	No		$9 \times \frac{5}{50} = 0.90$
	TOTAL	3.60	5.40

Illustration 4

On 1st April, 2009, Amazing Construction Ltd obtained a loan of ₹ 32 crores to be utilised as under :

		(₹ Crores)
(i)	Construction of sealink across two cities : (Work was held up totally for a month during the year due to high water levels)	25.00

(ii)	Purchase of equipments and machineries	3.00
(iii)	Working capital	2.00
(iv)	Purchase of vehicles	0.50
(v)	Advance for tools / cranes, etc.	0.50
(vi)	Purchase of technical know-how	1.00
(vii)	Total interst charged by the bank for the year ending 31st March, 2010	0.80

Show the treatment of interest by Amazing Construction Ltd. ***[C.A. (IPCC) — November, 2010]***

Solution

Borrowing Costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be ***capitalised as part of the cost of that asset***.

Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Amazing Construction Ltd
Statement Showing the Treatment of Interest **[all figures in ₹]**

Particulars	Qualifying Asset	Notes	Amount to be Capitalised	Amount to be Treated as Expense
1. Construction of Sealink	Yes	(1)	62,50,000	—
2. Purchase of Equipment and Machine	No	(2)		7,50,000
3. Working Capital	No	(3)		5,00,000
4. Purchase of Vehicles	No	(4)		1,25,000
5. Advance for Tools and Cranes	No	(5)		1,25,000
6. Purchase of Technical Know-how	No	(6)		2,50,000
Total	Total		62,50,000	17,50,000

It is to be noted that capitalisation of borrowing costs is not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

Notes :

(1) ₹ 25 crores out of ₹ 32 crores were used for construction of sealink. It is a ***qualifying asset***. Therefore, the amount to be capitalised = $\frac{80,00,000}{32 \text{ crores}} \times 25 \text{ crores}$ = ₹ **62,50,000**.

(2) ₹ 3 crores used for purchase of equipment and machinery will not be treated as qualifying asset. Therefore, interest on that amount will be treated as expense and will be charged to Profit and Loss Account. The amount to be charged to Profit and Loss Account = $\frac{80,00,000}{32 \text{ crores}} \times 3 \text{ crores}$ = ₹ **7,50,000**.

(3) ₹ 2 crores were used for working capital. The interest on this amount will be treated as an expense and it will be charged to Profit and Loss Account.
The amount will be : $\frac{80,00,000}{32 \text{ crores}} \times 2 \text{ crores}$ = ₹ **5,00,000**.

(4) ₹ 50,00,000 used for purchase of vehicles should not be treated as qualifying asset. The amount of interest for this amount will be treated as expense and it will be charged to Profit and Loss Account.
The amount will be : $\frac{80,00,000}{32 \text{ crores}} \times 0.5 \text{ crores}$ = ₹ **1,25,000**.

(5) ₹ 50,00,000 paid as advance for tools / cranes, etc. will not be treated as qualifying asset. Therefore, the interest on this amount will be treated as expense and it will be charged to Profit and Loss Account.
The amount will be : $\frac{80,00,000}{32 \text{ crores}} \times 0.5 \text{ crores}$ = ₹ **1,25,000**.

(6) Purchase of know-how for ₹ 1 crore will not be treated as qualifying asset. Therefore, interest on such amount will be treated as expense and it will be charged to Profit and Loss Account.
The amount will be : $\frac{80,00,000}{32 \text{ crores}} \times 1 \text{ crore}$ = ₹ **2,50,000**.

Problem Areas

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is co-ordinated centrally or when a range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgement is required.

Illustration 5

Axe Limited began construction of a new plant on 1st April, 2008 and obtained a special loan of ₹ 4,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.

The expenditures that were made on the project of plant were as follows :

1st April, 2008 — ₹ 5,00,000; 1st August, 2008 — 12,00,000; 1st January, 2009 — ₹ 2,00,000.

The company's other outstanding non-specific loan was ₹ 23,00,000 at an interest rate of 12% p.a..

The construction of the plant completed on 31st March, 2009.

You are required to :

(a) Calculate the amount of interest to be capitalised as per the provisions of AS-16 '***Borrowing Cost***'.

(b) Pass a journal entry for capitalising the cost and the borrowing cost in respect of the plant.

[C.A. (IPCC) — November, 2009]

Solution **(a) Amount of Interest Capitalised**

Particulars	₹
(i) Interest on specific borrowings (₹ 4,00,000 x 10%)	40,000
(ii) Interest on non-specific borrowings (₹ 13,50,000 – ₹ 4,00,000) x 12% (See Working Note)	1,14,000
Amount of Interest to be Capitalised	1,54,000

Calculation of Total Amount to be Capitalised

Cost of Plant (₹ 5,00,000 + ₹ 12,00,000 + ₹ 2,00,000)	19,00,000
Add: Amount of Interest to be Capitalised	1,54,000
	20,54,000

(b) Journal **Dr.** **Cr.**

Date	Particulars	L.F.	₹	₹
2009	Plant A/c Dr.		20,54,000	
Mar 31	To Bank A/c			20,54,000
	(Being the cost of plant and interest on borrowing for that capitalised)			

Working Note : Computation of Average Accumulated Expenses

		₹
1st April, 2008	₹ 5,00,000 × 12/12	5,00,000
1st August, 2008	₹ 12,00,000 × 8/12	8,00,000
1st January, 2009	₹ 2,00,000 × 3/12	50,000
		13,50,000

Temporary Investment Income

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.

Example : On 1st January, 2012 R.P. Ltd. has issued 10,00,000, 12% Debentures of ₹ 100 each for building a power plant in U.P. 50% of the fund was utilised during the period and the remaining 50% is to be used in the coming years. ₹ 5 crores was immediately invested in Mutual Funds of its group company. During the year ₹ 80 lakhs was received by way of dividend from mutual funds.

Here, borrowing costs is to be capitalised as follows :

Borrowing costs incurred on the borrowing of funds	**₹**
(₹ 10,00,000 × ₹ 12)	**120 lakhs**
Less: Income from investment of funds	**80 lakhs**
Amount to be capitalised in 2012	**40 lakhs**

Capitalisation Rate

To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a ***capitalisation rate*** to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Illustration 6

Your company J.S. Ltd. is building a steel plant costing ₹ 1000 crores. Long-term loan provided by Infrastructure Development Corporation Ltd to the extend of ₹ 500 crores @ 12% interest p.a.; the balance ₹ 500 crores comes from a pool of loans and 60% of the pooled loans cost 15% p.a. and 40% of the pooled loans cost 10% p.a. Calculate the average borrowing rate.

Solution

The cost of borrowings for the first year will be :		₹
(a) ₹ 500 crores @ 12% p.a.		60 crores
(b) ₹ 500 crores @ 13% p.a. (Working Note 1)		65 crores
	Total	125 crores

Average borrowing rate = $\frac{125}{1000} \times 100 = 12.5\%$

Working Note: **(1)** Weighted average rate of the pooled loan = (60% × 15%) + (40% × 10%) = 13%.

Illustration 7

How will you treat the following?

X Limited obtained a term loan of ₹ 1,160 lakhs for the acquisition of a plant on 1.4.2012. The loan was immediately utilised as : ₹ 812 lakhs for the acquisition of plant (which was ready for use on 31.3.2013); ₹ 116 lakhs for advance payment to suppliers for additional assets and the balance of ₹ 232 lakhs for financing working capital. For the year ended 31.3.2013, the total interest on the loan came to ₹ 104.40 lakhs.

Solution

Average Borrowing Rate = $\frac{104.40 \text{ lakhs}}{1{,}160 \text{ lakhs}} \times 100 = 9\%$

	₹
(a) Interest to be capitalised = 9% of ₹ 812 lakhs =	73.08 lakhs
(b) Interest to be shown as expense = 9% of (₹ 116 + 232)	31.32 lakhs
	104.40 lakhs

Commencement of Capitalisation

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

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;
(b) borrowing costs are being incurred; and
(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

Example 1 : On 1st January, 2015, your company HMC Ltd. has purchased land for a new motor cycle factory in NOIDA, U.P. 50% of the cost of the land has been paid to the owner of the land. For the purpose of this factory, company has taken ₹ 20 crores long-term loan from SBI at an interest cost of 12% p.a. The work of construction was started on 1st April, 2015.

Here, the capitalisation of borrowing cost has been commenced from 1st April, 2015.

Example 2 : In the above example, let us assume that the entire project will be financed from internal accruals. Here, no borrowing costs are being incurred, so no capitalisation is possible.

Example 3 : In Example 1, let us assume that the company will hold this land for one year, then sell it or develop it. Until then, no action is being taken to prepare the asset for use or sale.

Here, no activities has been undertaken to prepare the asset. So no capitalisation has been started.

Base Cost for Capitalisation

Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see Accounting Standard 12, Accounting for Government Grants).

Example : Your company Simplex Ltd. is building an IT Park in Chennai at a total cost of ₹ 100 crores. Tamil Nadu Government has given ₹ 10 crores as grant. Your company has received ₹ 50 crores from different IT companies as progressive payments.

The base cost of the project = ₹ 40 crores (100 crores – 10 crores – 50 crores). If we assume that borrowing cost is 10% p.a. and it was paid at the end of the year. Then the amount of borrowing cost to be capitalised = ₹ 4 crores (10% of ₹ 40 crores).

Suspension of Capitalisation

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

Example : Your company R.F. Ltd. is building a shopping mall at Kolkata by demolishing an old Kolkata Corporation Market. Because of protest by the existing traders of the market, the work has been suspended from 1 July, 2014. At 31 December 2014 (at the end of the accounting period) you are not sure when it will be possible to resume the work.

Capitalisation of borrowing cost should be suspended from 1st July, 2014 until the day it restarts.

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

Example 1 : Capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Example 2 : Your company JSW Ltd. is building a captive power plant in which natural gas will be used as fuel. Power generation station is ready but gas pipe line is yet to be ready. The power generation station can not work separately. So capitalisation will continue until the pipe line is ready for use.

Cessation of Capitalisation

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

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

For example, your company DLF Ltd. is building housing complex for higher income group at Mumbai. The housing complex is ready for sale but final clearance has not been received from Municipal Corporation.
Capitalisation of borrowing costs should cease from the time of completion of the project.

Illustration 7

In May, 2013 Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January 2014 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, 2014 amounted to ₹ 25 lakhs.

Can ₹ 25 lakhs be treated as a part of the cost of the factory building and thus be capitalised on the plea that the loan was specifically taken for construction of factory building ?

Solution

Para 19 of AS—16: "Borrowing Costs" states that capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Here, the construction of the factory building was completed in January 2005. The interest up to that date ₹ ***18 lakhs only is to be capitalised***. ₹ 7 lakhs will be charged to Profit and Loss Account.

Multipart Assets

When the construction of a qualifying asset is completed in parts and a c***ompleted part is capable of being used*** while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

Example : Your company U.T. Ltd. is building a business park comprising several buildings on the same site, each of which can be used individually. At the end of the accounting period 10 buildings have been completed substantially out of 50 buildings. So capitalisation of borrowing costs relating to 10 buildings should cease.

Illustration 8

J Ltd purchased machinery from K Ltd on 30.9.2008. The price was ₹ 370.44 lakhs after charging 8% sales tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges came to 1% on the quoted price.

A loan of ₹ 300 lakhs was taken from the bank on which interest at 15% p.a. was to be paid.

Expenditure incurred on the trial run was materials ₹ 35,000, wages ₹ 25,000 and overheads ₹ 15,000.

Machinery was ready for use on 1.12.2008. However, it was actually put to use only on 1.5.2014. Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2008 and 1.5.2009. The entire loan amount remained unpaid on 1.5.2014.

Solution

As per para 6 of AS-16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of the asset.

Calculation of the Cost of the Machine	₹ in Lakhs
Quoted price (₹ 370.44 × 100/108 × 100/98)	350.000
Less: Trade discount (@ 2% on ₹ 350 lakhs)	7.000
	343.000
Add: Sales tax (@ 8% on ₹ 343 lakhs)	27.440
	370.440
Add: Transportation charges (0.25% on ₹ 350 lakhs)	0.875
Installation charges (1% on ₹ 350 lakhs)	3.500
	374.815
Add: Expenditure on trial run —	
Materials	0.350
Wages	0.250
Overheads	0.150
	375.565
Add: Capitalisation of borrowing cost @ 15% on ₹ 300 lakhs (from 30.9.2008 to 1.12.2008)	7.500
Cost of the machine	383.065

As per para 19 of AS–16, capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Para 20 of AS-16 states that an asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue.

Therefore, the interest for the period 1.12.2008 to 1.5.2014 should be shown as an ***expense*** in the statement of profit and loss.

Illustration 10

XYZ Ltd has undertaken a project for expansion of capacity as per the following details (all figures in ₹):

	Plan	Actual
April 2014	2,00,000	2,00,000
May 2014	2,00,000	3,00,000
June 2014	10,00,000	—
July 2014	1,00,000	—
August 2014	2,00,000	1,00,000
September 2014	5,00,000	7,00,000

The company pays to its bankers @ 12% p.a., interest being debited on a monthly basis. During the half year the company had ₹ 10 lakhs overdraft upto 31st July, surplus cash in August and again overdraft of over ₹ 10 lakhs from 1.9.2014. The company had a strike during June and, hence, could not continue the work during June. Work was again commenced on 1st July and all the works were completed on 30th September. Assume that expenditure were incurred on 1st day of each month.

Calculate : (i) Interest to be capitalised; and (ii) Give reasons wherever necessary.

Assume :

(a) Overdraft will be less, if there is no capital expenditure.

(b) The Board of Directors based on facts and circumstances of the case has decided that any capital expenditure taking more than 3 months as substantial period of time.

Solution **Statement Showing Interest to be Capitalised**

Date 2014	Actual Expenditure ₹	Interest @ 1% p.a. ₹	Cumulative Amount ₹
April	2,00,000	2.000	2,02,000
May	3,00,000	5.020	5,07,020
June	NIL	5.070	5,12,090 (Note 1)
July	NIL	5.121	5,17,211
August	1,00,000	NIL	6,17,211 (Note 2)
September	7,00,000	13.172	13,30,383

Note 1 As per para 18 of AS-16, borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

As the Board of Directors based on facts and circumstances of the case has decided that any capital expenditure taking more than 3 months as substantial period of time. Therefore, the effect of the strike can be ignored and, in effect, interest for the month of June can be capitalised.

Note 2 In August, no interest should be capitalised since there is surplus cash. As the work has been completed on 30.9.2014, no interest will be capitalised thereafter.

Disclosure

The financial statements should disclose :

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the period.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Which of the following statement is true ?
   A Borrowing costs may include interest on bank borrowings and other short-term and long-term borrowings.
   B Borrowing costs may include interest and commitment charges on bank borrowings and other short-term borrowings.
   C Borrowing costs may include interest and commitment charges on bank borrowings and other short-term and long-term borrowings.
2. A qualifying asset is an asset that necessarily takes :
   A a short period of time to get ready for its intended use or sale
   B a substantial period of time to get ready for its intended use or sale
   C a very very long period of time to get ready for its intended use or sale
3. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that :
   A they will result in future economic benefits to the enterprise and the cost may not be measured reliably
   B they will not result in future economic benefits to the enterprise but the cost can be measured reliably
   C they will result in future economic benefits to the enterprise and the cost can be measured reliably
4. Temporary investment income generated from loans taken in order to finance qualifying asset should be:
   A added to the borrowing costs
   B deducted from the borrowing costs
   C shown as income in the profit and loss account
5. Borrowing costs are
   A always capitalised
   B never capitalised
   C sometimes capitalised
6. Borrowing costs should be recognised as an expense and charged to the profit and loss account of the period in which they are incurred :
   A If the borrowing costs relate to qualifying asset
   B If the borrowing costs relate to current fast-moving inventory
   C none of the above

7. Mohan Meakin Ltd. is manufacturing high quality wine which will take 6 years to mature. The inventory of wine :
   A is not a qualifying asset
   B is a qualifying asset
   C is a fixed asset
8. Capitalisation of borrowing costs should commence when
   1. expenditure for acquisition, construction or production of a qualifying asset is being incurred;
   2. borrowing costs are being incurred;
   3. activities that are necessary to prepare the asset for its intended use or sale are in progress.
   Which of the following alternatives is correct ?
   A 2 and 3
   B 1, 2 and 3
   C 1 and 3
9. Capitalisation of borrowing costs should be suspended during extended periods :
   A if the active development is interrupted temporarily
   B if the active development is interrupted permanently
   C neither of A and B above
10. Capitalisation of borrowing costs should cease :
   A when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete
   B when all the activities necessary to prepare the qualifying asset for its intended use or sale are complete
   C neither of A and B above

PRACTICAL QUESTIONS

1. On 25th April, 2014, Neel Limited obtained a loan from the bank for ₹ 70 lakhs to be utilised as under : Construction of factory shed — ₹ 28 lakhs; Purchase of machinery — ₹ 21 lakhs; Working capital — ₹ 14 lakhs; and Advance for purchase of truck ₹ 7 lakhs.
   In March, 2015 construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31st March, 2015 was ₹ 12 lakhs. Show the treatment of interest AS-16. ***[C.A. (IPCC) — Adapted]***
2. X Limited began construction of a new plant on 1st April, 2011 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 :
   1.4.2011 — ₹ 10,00,000;
   1.8.2011 — ₹ 24,00,000; and
   1.1.2012 — ₹ 4,00,000.
   The company's other outstanding non-specific loan was ₹ 46,00,000 at an interest of 12 per cent per annum.
   The construction of the plant was completed on 31.3.2012.
   You are required to calculate the amount of interest to be capitalised as per the provision of AS-16 of the borrowing cost (including cost). ***[C.A. (Final) — May, 2012]***

Guide to Answer

Multiple Choice

1. C; **2.** B; **3.** C; **4.** B; **5.** C; **6.** B; **7.** B; **8.** B; **9.** B; **10.** A

Practical Questions

1. (i) Amount to be capitalised ₹ 4.80 lakhs
   (ii) Amount to be charged to Profit and Loss Account ₹ 7.20 lakhs.
2. (i) Amount of interest to be capitalised : ₹ 3,08,000
   (ii) Total cost of plant : ₹ 41,08,000.

AS — 19 : Leases
[Effective Date : 1st April, 2001]

Introduction

A ***Lease*** is a contract by which the owner of an asset, the ***Lessor***, allows another person, the ***Lessee***, to use it in exchange for regular payments. Leasing has become extremely common in the business world. From the lessee's point of view, ***leasing*** provides an alternative to the purchase of an asset required for use in the business. The main distinguishing feature of leasing is that the lessee never obtains legal ownership of the asset during lease period. The advantage is that the lessee obtains the unrestricted use of the asset for a specified period without incurring major capital expenditure or incurring long-term loan, while the rental can be paid to the lessor out of the income generated by the use of the asset over that specified period.

The range of assets covered by the leasing agreements is very wide. Plant and Machinery, Land and Buildings, Cars, Ships and Aircraft are frequently leased.

Before the introduction of AS—19 : Leases, many enterprises were disclosing in the Balance Sheet neither the leased assets nor the full lease liabilities. Now, AS—19 ensures that the entity controlling the assets, irrespective of ownership, ***recognises the assets and resulting liability*** in order to provide a true and fair view of the financial position.

Objective

The objective of this Statement is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

Scope

This Statement should be applied in accounting for all leases other than:

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

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

(c) lease agreements to use lands.

This Statement applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.

Example : X Ltd. has taken on lease a fully furnished office. The lessor provides secretarial services and all office equipments. This is covered by AS—19.

This Statement does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

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

Lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Finance Lease

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

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

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

(a) upon the occurrence of some remote contingency; or
(b) with the permission of the lessor; or
(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Inception of the Lease
The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

Lease Term
The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum Lease Payments
Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or
(b) in the case of the lessor, any residual value guaranteed to the lessor:
    i. by or on behalf of the lessee; or
    ii. by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Fair Value
Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Economic Life
Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or
(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful Life
Useful life of a leased asset is either:

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

Residual Value
Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

Guaranteed Residual Value
Guaranteed residual value is:

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

Unguaranteed Residual Value

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

> **Example : Magma Leasing Ltd. has given a car on lease for 4 years to Sita Travels Ltd. The cost of the car is ₹ 5,00,000. The estimated residual value of the car is ₹ 50,000 at the end of the lease.**
> **A dealer of 2nd hand car gives a guarantee to purchase the car for ₹ 40,000 at the end of the lease period. This ₹ 40,000 is the guaranteed residual value. The remaining ₹ 10,000 is the unguaranteed residual value.**

Gross Investment

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

Unearned Finance Income

Unearned finance income is the difference between:

(a) the gross investment in the lease; and

(b) the present value of

 (i) the minimum lease payments under a finance lease from the standpoint of the lessor; and

 (ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease (***See Illustration 2***).

Net Investment

Net investment in the lease is the gross investment in the lease less unearned finance income.

Interest Rate Implicit in the Lease

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Lessee's Incremental Borrowing Rate of Interest

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent Rent

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

> **Example : Fast Food Ltd. has taken a restaurant on lease in New Delhi Railway Station. Rent payable per month is ₹ 20,000 plus 10% of sales as contingent rent.**

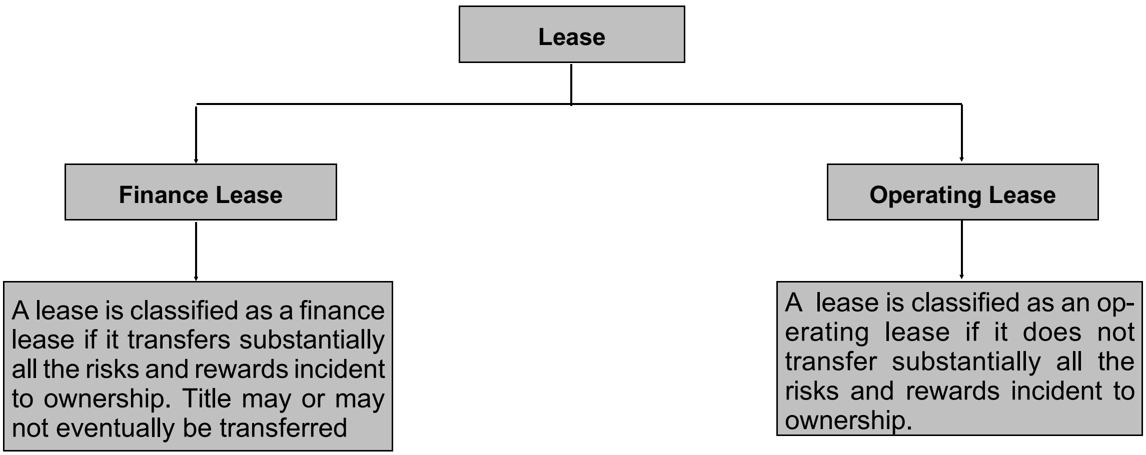
Hire Purchase

The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last installment and the hirer has a right to terminate the agreement at any time before the property so passes.

Classification of Leases

The classification of leases adopted in this Statement is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee.

Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.



Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a ***finance lease*** are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

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

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

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

Indicators of situations which individually or in combination could also lead to a lease being classified as a ***finance lease*** are:

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

Example : Your company, Go Airways Ltd. has taken on lease an aircraft for 5 years. If the company wants to cancel the lease, it will have to pay all the remaining payment up to the end of the lease. This is a finance lease, because there is no way of paying a reduced rental.

(b) gains or losses from the ***fluctuation in the fair value of the residual fall to the lessee*** (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

Example : Magma Leasing Ltd. has given a car on lease for 4 years to Sita Travels Ltd. The cost of the car is ₹ 5,00,000. The estimated residual value is ₹ 50,000.
As per the terms and conditions of the lease, if the car's residual value is more than ₹ 50,000, When the car is sold, Sita Travels Ltd. (lessee) will receive the excess money.
If it is less than ₹ 50,000, Sita Travels Ltd. will have to pay Magma Leasing Ltd. the deficit amount.
This is a financial lease.

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

Example : Your company Modern Printer Ltd. has taken on lease a printing machine for 5 years at a commercial rent from HMT Ltd. At the end of the lease period, your company can continue to rent at 1/10th of the present rental but a service contract is to be signed with the HMT Ltd.
HMT Ltd. does not want the printing machine back. It would prefer to leave it with the lessee for a minimum rent and earn some income from service contract.
This is a finance lease, as the lessor wants that the lessee should enjoy the entire economic life of the machine.

Lease classification is made at the ***inception of the lease***. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

Illustration 1

On 1st January, 2015 Gamon India Ltd. leased a heavy duty new crane from Magma Leasing Co. Ltd. The capital cost of the crane is ₹ 25,00,000. 6 half-yearly payments of ₹ 5,00,000 are payable. 1st installment is payable on 1st January, 2015. The estimated economic life of the crane is 5 years with a nil residual value. The leasing company has offered a secondary term of 3 years for ₹ 2,00,000 per annum only. Gamon India Ltd. has not yet decided if they will accept it.

After the expiry of lease period, the crane is expected to have a residual value of ₹ 5,00,000. As per the lease agreement, Gamon India Ltd. will get 90% of the proceeds should the assets be sold.

How this lease should be classified ?

Solution

The minimum lease payment = (₹ 5,00,000 × 6)	₹	30,00,000
Fair value of the asset (capital cost)	₹	25,00,000
Finance Charge	₹	5,00,000

This will be classified as a finance lease on the following grounds :

(i) The primary lease period is 3 years which is majority of asset's economic life.
(ii) The lessee has the option to extend the lease for a secondary period at a much lower rent.
(iii) The lessee will get 90% of the proceeds of sale of the crane.

Illustration 2

An equipment is leased for 3 years and its useful life is 5 years. Both the cost and the fair value of the equipment are ₹ 3,00,000. The amount will be paid in 3 installments and at the termination of lease — lessor will get back the equipment. The unguaranteed residual value at the end of 3 years is ₹ 40,000. The Implicit Rate of Return (IRR) of the investment is 10%. The present value of annuity factor of Re 1 due at the end of 3rd year at 10%. IRR is 2.4868. The present value of Re 1 due at the end of 3rd year at 10% rate of interest is 0.7513.

(i) State with reason whether the lease constitutes finance lease.
(ii) Calculate unearned finance income. ***[C.A. (Final) — May, 2010]***

Solution (i)

This lease constitutes finance lease on the following grounds :

(1) The primary lease period is 3 years which is majority of assets' economic value.
(2) The present value of lease payments is 89.98% (See Working Note below) of the fair value which is substantial portion thereof.

Working Note :

Present value of residual value — ₹ 40,000 × 0.7513 = ₹ 30,052.
Present value of lease payment — ₹ 3,00,000 – ₹ 30,052 = ₹ 2,69,948.

Percentage of fair value = $\frac{\text{Rs } 2,69,948}{\text{Rs } 3,00,000}$ = 89.98%

Solution (ii)

Annual lease payments = $\frac{\text{Rs } 2,69,948}{2.4868}$ = Rs 1,08,552

Annual lease payment has been calculated on the basis that :
[Present value of lease payments plus residual value = Fair value of the assets (cost)].

	₹
Gross investment in the lease [(₹ 1,08,552 × 3) + ₹ 40,000]	3,65,656
Less: Cost of the equipment	3,00,000
Unearned finance income	65,656

Leases in Financial Statement of Lessees

Finance Leases

At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Illustration 3

X Ltd wishes to acquire a new machine. The company could purchase outright for cash for ₹ 8,10,000 or alternatively, enter into a finance lease agreement. The asset has an estimated useful life of 5 years with a residual value of ₹ 4,250. The terms and conditions of the finance lease agreement are as follows :

(i) Minimum lease payment ₹ 2,00,000 p.a. payable on first day of each year.
(ii) Lessee is responsible for insurance and maintenance of the machine.

You are required to calculate :
(i) interest rate implicit in lease; and
(ii) present value of minimum lease payment.

Solution

(i) Interest Rate Implicit in Lease

This is the discount rate, which when applied at the outset of the lease equates the following :

(a) the fair value of the asset;
(b) the present value of minimum lease payments plus any **unguaranteed residual value**.

Here in this ***Illustration***,

(a) Fair value of the asset = ₹ 8,10,000.
(b) Present value of lease payment at different rate of interest is calculated as follows :

Lease Payments (Beginning)	Present Value Factor at 11%	Present Value of Lease Payments	Present Value Factor at 12%	Present Value of Lease Payments	Present Value Factor at 13%	Present Value of Lease Payments
2,00,000	1	2,00,000	1	2,00,000	1	2,00,000
2,00,000	.900	1,80,000	.893	1,78,600	.885	1,77,000
2,00,000	.811	1,62,200	.797	1,59,400	.783	1,56,600
2,00,000	.731	1,46,200	.712	1,42,400	.693	1,38,600
2,00,000	.659	1,31,800	.636	1,27,200	.613	1,22,600
*4,250 (*at the end of 5th year)	.593	2,520	.567	2,410	.543	2,308
		8,22,720		8,10,010		7,97,108

From the above calculation, it is clear that 12% rate of interest will equate the fair value.

Therefore, 12% is the implicit rate of interest in the lease.

(ii) Present Value of Minimum Lease Payments (12% rate of interest)

Year (Beginning)	Amount of Lease Payments	Present Value of Re 1	Present Value of Lease Payments
1	2,00,000	1	2,00,000
2	2,00,000	.893	1,78,600
3	2,00,000	.797	1,59,400
4	2,00,000	.712	1,42,400
5	2,00,000	.636	1,27,200
	10,00,000		8,07,600

It should be noted that the lessee will record the machine at ₹ 8,07,600, although the fair value of the asset is ₹ 8,10,000.

Presentation of the Asset and Liability

Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

Initial Direct Cost

Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Apportion of Lease Payments

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Schedule of payments, split between capital and interests is normally available from the lessor.

Depreciation and Impairment

A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets, that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

Illustration 4

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 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 the Lessee Ltd. and the interest (finance charges) in each year.

[C.A. (IPCC) — May, 2011]

Solution **Calculation of Present Value of Minimum Lease Payments**

End of	Minimum Lease Payments	Present Value at 15%	Present Value Amount (₹)
1st Year	3,00,000	0.869	2,60,700
2nd Year	3,00,000	0.756	2,26,800
3rd Year	3,00,000	0.657	1,97,100
	(Residual Value) 22,000	0.657	14,454
			6,99,054

Value of machine will be the lower of fair value and present value of minimum lease payment *plus* residual value. Hence, present value of minimum lease payment *plus* residual value is ₹ 6,99,054 but the fair value is ₹ 7,00,000. Therefore, the value of machine will be taken as ₹ **6,99,054**.

Calculation of Interest (Finance Charge)

Year (A)	Balance Due (₹) (B)	Interest @ 12% for the Year (15% of B) (C)	Repayment of Capital (₹ 3,00,000 – C) (₹) (D)	Closing Balance (B – D) (₹) (E)
1st	6,99,054	1,04,858	1,95,142	5,03,912
2nd	5,03,912	75,587	2,24,413	2,79,499
3rd	2,79,499	41,925	2,58,075	*21,424 (Residual Value)

*The difference between this figure and guaranteed residual value (₹ 22,000) is due to approximation.

Illustration 5

R Limited (the Lessee) acquired a machinery on lease from S Limited (the Lessor) on January 1, 2010. The lease term covers the entire economic life of the machinery, i.e., 3 years. The fair value of the machinery on January 1, 2010 is ₹ 3,50,000. The lease agreement requires the lessee to pay an amount of ₹ 1,50,000 per year beginning December 31, 2010. The lessee has guaranteed a residual value of ₹ 11,400 on December 31, 2012 to the lessor. The lessor, however, estimates that the machinery will have a salvage value of only ₹ 10,000 on December 31, 2012. The implicit rate of interest is 15% p.a. Compute the value of machinery to be recognised by the lessee and also the finance charges every year on the basis of AS-19. (P.V. Factor of 15% in three years is 2.283).

Solution

In this case, the lease is to be classified as a ***finance lease***, since the lease term covers the entire economic life of the machinery.

A finance lease should be recorded in the books of the lessee as if it were the purchase of the property rights with an asset, with a simultaneous recognition of the obligation to pay future rentals. The asset represents the capitalised value of the lease. The liabilities side represents the capital element of future rentals payable. The asset and the liability for the future lease payments are recognised in the Balance Sheet at the same amounts.

The amount to be capitalised by the lessee should be the present value of minimum lease rentals *plus* guaranteed residual value, discounted at the rate of interest implicit in the lease, i.e., 15%.

	₹
The present value of the minimum lease payments is as under :	
Present value of annual lease payments (₹ 1,50,000 × 2.283)	3,42,450
Present value of guaranteed residual value (₹ 11,400 × 0.6575)	7,496
Present value of minimum lease payments	3,49,946

The periodic rentals paid to the lessor are apportioned between (a) repayment of capital; and (b) a finance charge. The total finance charge is the amount by which the rentals paid to the lessor exceeds the fair value of the asset. The total finance charge should be allocated to accounting periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance.

This is shown as under:

Year	Finance Charges (₹)	Annual Payment (₹)	Reduction in Principal Amount (₹)	Outstanding Liability (₹)
I. 01.01.2010	—	—	—	3,49,946
31.12.2010	52,492 (15% on ₹ 3,49,946)	1,50,000	97,508	2,52,438
II. 31.12.2011	37,866 (15% on ₹ 2,52,438)	1,50,000	1,12,134	1,40,304
III. 31.12.2012	21,046 (15% on ₹ 1,40,304)	1,50,000	1,28,954	11,350

Disclosures

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

a. assets acquired under finance lease as segregated from the assets owned;
b. for each class of assets, the net carrying amount at the balance sheet date;
c. a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
   (i) not later than one year;
   (ii) later than one year and not later than five years;
   (iii) later than five years;
d. contingent rents recognised as expense in the statement of profit and loss for the period;
e. the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and
f. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
   (i) the basis on which contingent rent payments are determined;
   (ii) the existence and terms of renewal or purchase options and escalation clauses; and
   (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Operating Leases

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis.

Disclosures

The lessee should make the following ***disclosures for operating leases***:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
  (i) not later than one year;
  (ii) later than one year and not later than five years;
  (iii) later than five years;

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

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

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

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
  (i) the basis on which contingent rent payments are determined;
  (ii) the existence and terms of renewal or purchase options and escalation clauses; and
  (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Leases in the Financial Statements of Lessors

Finance Leases

An enterprise, e.g., a finance or a leasing company buys an asset from outside with the specific purpose of leasing it to a lessee. The lessor of a finance lease treats the transaction as ***a sale of an asset*** on long-term credit with the assumption that collection of periodic rentals is reasonably certain and there is no uncertainty about the future costs to be incurred with regard to the transaction. Therefore, a finance lease should be recorded in the lessor's Balance Sheet as a long-term ***debtor*** at the amount of the ***net investment in the lease***. Therefore, in the books of the lessor, a physical asset is converted into a non-current financial asset, i.e., debtors.

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

Where the cash flows under a finance lease may be predicted with reasonable certainty, the total finance charge should be allocated to different accounting periods during the lease term so as to produce a constant periodic rate of return on the remaining balance. This means to apply the finance charges at a constant percentage on the reducing net investment in the asset being leased.

The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Disclosures

The lessor should make the following disclosures for ***finance leases***:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
  (i) not later than one year;
  (ii) later than one year and not later than five years;
  (iii) later than five years;

(b) unearned finance income;
(c) the unguaranteed residual values accruing to the benefit of the lessor;
(d) the accumulated provision for uncollectible minimum lease payments receivable;
(e) contingent rents recognised in the statement of profit and loss for the period;
(f) a general description of the significant leasing arrangements of the lessor; and
(g) accounting policy adopted in respect of initial direct costs.

Illustration 6

Global Ltd. has initiated a lease for three years in respect of an equipment costing ₹ 1,50,000 with expected useful life of 4 years. The asset would revert to Global Ltd. under the lease agreement.

The other information available in respect of lease agreement are :

(i) the unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹ 20,000;
(ii) the implicit rate of interest is 10%; and
(iii) the annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Global Ltd. :

(i) Annual Lease Payment;
(ii) The unearned finance income;
(iii) The segregation of financial income;

Solution

(i) Calculation of Annual Lease Payment
(Assumed to be paid at the end of the year)

	₹
Cost of the equipment	1,50,000
Unguaranteed residual value	20,000
Present value of residual value @ 10% (₹ 20,000 × 0.7513)	15,026
Fair Value to be Recovered for Lease Payment	
Cost of equipment	1,50,000
Less: Present value of residual value	15,026
	1,34,974

Cumulative P.V. for 3 years @ 10% = 2.4868 (See Annuity Table)

$$\text{Annual Lease Payment} = \frac{1,34,974}{2.4868} = ₹\ 54,276$$

(ii) Unearned Financial Income

Total lease payments (₹ 54,276 × 3)	1,62,828
Add: Residual value	20,000
Gross Investments	1,82,828
Less: Cost of equipment	1,50,000
	32,828

(iii) Calculation of Finance Income

Year	Lease Rentals (₹)	Finance Charges @ 10% on outstanding amount of the year (₹)	Repayment (₹)	Outstanding Liability (₹)
0	—	—	—	1,50,000
1	54,276	15,000	39,276	1,10,724
2	54,276	11,072	43,204	67,520
3	74,276 (Including residual value)	*6,756	67,520	—

* Actual interest is ₹ 6,752. The difference is due to approximation which has been adjusted in finance charge.

Operating Leases

An asset held by a lessor under an operating lease is required to be recorded as a fixed asset because the lessor keeps with himself all the substantial burdens and benefits of ownership.

The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

Rental income is recognised in the Profit and Loss Account is a revenue to the lessor on a straight-line basis, even if the payments are not received on such a basis. However, if another systematic and rational basis is more representative of the time pattern in which the lessor receives rentals, it can also be used.

Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, Depreciation Accounting.

Disclosure

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

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
  - (i) the depreciation recognised in the statement of profit and loss for the period;
  - (ii) impairment losses recognised in the statement of profit and loss for the period;
  - (iii) impairment losses reversed in the statement of profit and loss for the period;

(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
  - (i) not later than one year;
  - (ii) later than one year and not later than five years;
  - (iii) later than five years;

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

(d) a general description of the lessor's significant leasing arrangements; and

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

Journal Entries

1. For the purchase of the asset

Asset Account	Dr.
To Bank Account	

2. For the rental received on lease

Bank Account	Dr.
To Lease Rent Account	

3. For the depreciation of the asset

Depreciation Account	Dr.
To Provision for Depreciation Account	

4. For the payment of taxes, insurance and maintenance of the asset

Taxes Account	Dr.
Insurance Account	Dr.
Maintenance of Leased Asset Account	Dr.
To Bank Account	

Sale and Leaseback Transactions

A sale and leaseback transaction occurs when an owner sells an asset and immediately reacquires the right to use the asset by entering into a lease with the purchaser—which may be either a finance lease or an operating lease. The original owner of the asset becomes the lessee of a lease agreement and the purchaser, the lessor.

For the purpose of sale and leaseback, the asset is generally sold to a finance or leasing company. The sum of the periodic rentals or lease period is independent of the selling price of the asset and may not represent the asset's fair value. There is no specific problem as far as the lessor is concerned. His net cash investment is the purchase price and that should be equal to the present value of minimum lease payments. In his books, accounting treatments are same as what has been explained previously.

From the lessee's point of view, the accounting problem is at what amount should the asset be recorded in the books and, in effect, when he should recognise a gain or loss from the sale of the asset that is now being used.

If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Example : P Ltd. had a property in Kolkata. The carrying amount of the property is ₹ 50,00,000. The company has entered into an agreement with a leasing company for sale and leaseback.
P Ltd. received ₹ 70,00,000. As per terms and conditions of the lease agreement, it will be treated as a finance lease.
The profit of ₹ 20,00,000 will be amortised over the lease term in proportion to the depreciation of the leased asset.

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately.

Example : P Ltd. had a property in Kolkata. The carrying amount of the property is ₹ 50,00,000. The company has entered into an agreement with a leasing company for sale and leaseback.
P Ltd. received ₹ 60,00,000. As per terms and conditions of the lease, it will be treated as an operating lease.
The profit of ₹ 10,00,000 will be recognised as profit immediately.

If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by ***future lease payments at below market price***, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Example : P Ltd. had a property in Kolkata. The carrying amount of the property is ₹ 50,00,000. The company has entered into an agreement with a leasing company for sale and leaseback.
P Ltd. will pay reduced lease payment and agreed to sale the property for ₹ 48,00,000. This ₹ 2,00,000 discount will be amortised over leased term.
Let us assume that the property was sold for ₹ 54,00,000 (other things remaining same).
The profit of ₹ 4,00,000 will be amortised over leased term.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Illustration 7

X Ltd sold JCB Machine having WDV of ₹ 50 lakhs to Y Ltd for ₹ 60 lakhs and the same JCB was leased back by Y Ltd to X Ltd. The lease is operating lease.

Comment according to relevant Accounting Standard if :

(i) Sale price of ₹ 60 lakhs is equal to fair value;
(ii) Fair value is ₹ 50 lakhs and sale price is 45 lakhs;
(iii) Fair value is ₹ 55 lakhs and sale price is ₹ 62 lakhs; and
(iv) Fair value is ₹ 45 lakhs and sale price is ₹ 48 lakhs.

[C.A. (IPCC) — May, 2012]

Solution

(i) It is an operating lease. The sale price of ₹ 60 lakhs is equal to fair value. Therefore, the profit arising from sale, i.e., ₹ 60 lakhs – ₹ 50 lakhs = ₹ 10 lakhs should be recognised immediately in its book.

(ii) Fair value is ₹ 50 lakhs but sale price is ₹ 45 lakhs. The loss of ₹ 5 lakhs (50 lakhs – 45 lakhs) should be recognised in the books of account. It is assumed that the lease payment will be same as market rate.

(iii) Book value is ₹ 50 lakhs and sale price is ₹ 62 lakhs. Therefore, total profit is ₹ 12 lakhs (62 lakhs – 50 lakhs).
Out of ₹ 12 lakhs, ₹ 5 (55 – 50), the difference between fair value and WDV will be recognised immediately and the balance ₹ 7 lakhs (62 – 55) is to be amortised over leased period.

(iv) When fair value is ₹ 45 lakhs and sale price is ₹ 48 lakhs, the loss of ₹ 5 lakhs (₹ 50 lakhs – 45 lakhs) should be recognised immediately in the books of account. The profit of ₹ 3 lakhs (48 lakhs – 45 lakhs) should be amortised over lease period.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Minimum lease payments are :
   (i) payments over the lease term, the lessee is to make
   (ii) contingent rent
   (iii) any residual value guaranteed by the lessee.
   Which of the following is correct ?
   A (i), (ii) and (iii)
   B (i) and (iii)
   C (i) and (ii)
2. Gross investment in the lease is the aggregate of the
   A minimum lease payments under finance lease from the stand point of the lessor
   B minimum lease payments under finance lease from the stand point of the lessor and any guaranteed residual value accruing to the lessor
   C minimum lease payments under finance lease from the stand point of lessor and any unguaranteed residual value accruing to the lessor
3. Leased assets appear in the Balance Sheet of the lessee in the case of
   A all leases
   B operating leases
   C finance leases
4. Lease liabilities are
   A long-term liability
   B current liability
   C split between A and B

5. At the beginning of the lease
   A major portion of the payment is principal, with a small element of interest
   B major portion of the payment is interest, with a small element of principal
   C the principal and interest payments are equal
6. Contingent rent must be
   A added to the lease liability
   B charged as expense
   C treated as deferred revenue expenditure
7. Lessors shall record assets, given under a finance lease
   A as a leased asset
   B as held-for-sale assets
   C as a receivable
8. Initial direct costs of the lessee, such as in negotiating and securing leasing arguments are
   A charged immediately by the lessee
   B added to the amount recorded as an asset
   C added with contingent rent
9. A finance lease gives rise to a depreciation expense for the depreciable assets. The depreciation policy for leased asset should
   A match the period of the lease
   B be consistent with that for depreciated assets which are owned
   C be average of A and B
10. An asset given under operating lease should be presented in the Balance Sheet of the
   A lessee as a fixed asset
   B lessor as a fixed asset
   C lessor as a current asset

PRACTICAL QUESTIONS

1. B&P Ltd availed a lease from N&L Ltd. The conditions of the lease terms are as under :
   (i) Lease period is 3 years in the beginning of the year 2011 for equipment costing ₹ 10,00,000 and has an expected useful life of 5 years.
   (ii) The fair market value is also ₹ 10,00,000.
   (iii) The property reverts back to the lessor on termination of the lease.
   (iv) The unguaranteed residual value is estimated at ₹ 1,00,000 at the end of the year 2013.
   (v) 3 equal annual payments are made at the end of each year.

   Consider IRR = 10%.
   The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is ₹ 0.7513.
   The present value of annuity of ₹ 1, due at the end of 3rd year at 10% IRR, is ₹ 2.4868.
   State whether the lease constitute finance lease and also calculate unearned finance income.

   [C.A. (IPCC) — May, 2010]
2. An equipment having expected useful life of 5 years, is leased for 3 years. Both the cost and the fair value of the equipment are ₹ 6,00,000. The amount will be paid in 3 equal instalments and at the termination of lease, lessor will get back the equipment.
   The unguaranteed residual value at the end of 3rd year is ₹ 60,000. The IRR of the investment is 10%. The present value of annuity factor of ₹ 1 due at the end of 3rd year at 10% IRR, is 2.4868. The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is 0.7513.
   State with reason whether the lease constitutes finance lease and also compute the unearned finance income.

   [C.A. (IPCC) — November, 2011]

Guide to Answers

Multiple Choice

1. B; **2.** B; **3.** C; **4.** C; **5.** B; **6.** B; **7.** C; **8.** B; **9.** B; **10.** B

Practical Questions

1. (i) This lease constitute finance lease on the following grounds :
   (a) Primary lease period is 3 years which is majority of assets' economic value.
   (b) The present value of lease payments is 92.48% of the fair value which is substantial portion thereof.
   (ii) Unearned finance insome = ₹ 2,15,735.
2. (i) This lease constitute finance lease on the following grounds :
   (a) Primary lease period is 3 years which is majority of assets' economic value.
   (b) The present value of lease payments is 92.48% [₹ 5,54,922 ÷ ₹ 6,00,000) × 100] of the fair value which is substantial portion thereof.
   (ii) Unearned finance income = ₹ 1,29,441.

AS — 20 : Earnings Per Share
[Effective Date : 1st April, 2001]

Introduction

Readers of financial statements use earnings per share (EPS) data in evaluating the operating performance and profitability of a company. It is also used for comparisons between different companies in the same reporting period and between different reporting periods of the same company.

Recognising the importance of this information, AS—20 requires that an enterprise should present ***basic*** and ***diluted*** earnings per share on the face of the statement of profit and loss.

Objective

The objective of this Statement is to prescribe principles for the determination and presentation of earnings per share. The focus of this Statement is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances the quality of financial reporting.

Scope

This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India.

An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

However, in respect of accounting periods commencing on or after 1-4-2009, if any such enterprise does not fall in any of the following categories, it need not disclose diluted earnings per share (both including and excluding extraordinary items) and information required under this Standard :

(i) Enterprises whose equity securities or potential equity securities are listed outside India and enterprises whose debt securities (other than potential equity securities) are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 10 crores at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

In consolidated financial statements, the information required by this Statement should be presented on the basis of consolidated information.

It should be noted that every company which is required to give information under Part IV of Revised Schedule VI to the Companies Act, 1956, should calculate and disclose 'Diluted EPS' in accordance with AS—20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Definitions

For the purpose of this Statement, the following terms are used with the meanings specified:

An ***equity share*** is a share other than a preference share.

A ***preference share*** is a share carrying preferential rights to dividends and repayment of capital.

A ***financial instrument*** is any contract that gives rise to both a ***financial asset*** of one enterprise and a ***financial liability*** or equity shares of another enterprise.

For this purpose, a financial asset is any asset that is

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

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

(a) debt instruments or preference shares, that are convertible into equity shares;

(b) share warrants;

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

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

Example : X Ltd.'s preference shares can be converted into an equal number of equity shares in 3 years' time. These are potential equity shares, even though the company do not know whether the holders will convert them. All will depend on the price of each class of share at the time of conversion. If the price of the equity share is more than that of preference share, the holder will convert and will make a profit. If the price of equity share is less than that of preference share the holder will not convert it into equity shares.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Example : X Ltd. issued debentures at a reduced rate of interest by offering a warrant with each debenture.

Each warrant allows the holder to acquire a share @ ₹ 150 each in 2 years' time. The present market price of share is ₹ 250 each.

If the market price is above ₹ 150 at that time, the debentureholder will acquire equity share at a lesser price by utilising warrant and will make profit.

If the market price is less than ₹ 150, the warrant will not be exercised, because the debentureholder can buy equity shares from the market at lower price.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Presentation

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

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

Measurement

Basic Earnings Per Share

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

Example : Capital structure of R Ltd. is as under :
(i) Equity Shares of ₹ 100 each — 1,00,000 (outstanding for the whole year).
(ii) 12% Preference Shares of ₹ 100 each — 50,000 (outstanding for the whole year).
During the year 2014-15, the company earned a profit of ₹ 20,00,000 after tax.

$$\text{Basic EPS} = \frac{\text{Net Profit} - \text{Preference Dividend}}{\text{Weighted Average Number of Equity Shares Outstanding During the Year}}$$

$$= \frac{20{,}00{,}000 - 6{,}00{,}000}{1{,}00{,}000} = ₹\ 14$$

Earnings — Basic

All items of income and expense which are recognised in a period, including ***tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless*** an Accounting Standard requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

(a) the amount of any preference dividends on non-cumulative preference shares provided for in respect of the period

Example : In 2014, R Ltd. could not pay ₹ 6,00,000 dividend on non-cumulative preference shares. In 2015, R Ltd. paid ₹ 6,00,000 preference dividend for the current year.
For 2014, no preference dividend expense has been incurred. However, for 2015 ₹ 6,00,000 to be included as the expense of the preference dividend.

(b) the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

Example : In 2014, R Ltd. could not pay ₹ 6,00,000 dividend on cumulative preference shares.
In 2014, R Ltd. paid ₹ 12,00,000 preference dividend, out of which ₹ 6,00,000 is related to the year 2014.
Though dividend on cumulative preference shares could not be paid in 2014, still ₹ 6,00,000 is to be included as the expense of preference dividend for 2014.
For 2015, out of ₹ 12,00,000, only ₹ 6,00,000 will be included as the expense of the preference dividend.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per Share — Basic

For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Example — Weighted Average Number of Shares (Accounting year 1-1-2012 to 31-12-2012)

		No. of Shares Issued	No. of Shares Bought Back	No. of Shares Outstanding
1st January, 2012	Balance at beginning of year	1,800	—	1,800
31st May, 2012	Issue of shares for cash	600	—	2,400
1st Nov., 2012	Buy Back of shares	—	300	2,100
31st Dec., 2012	Balance at end of year	2,400	300	2,100

Computation of Weighted Average :
(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.
The weighted average number of shares can alternatively be computed as follows :
(1,800 x 12/12) + (600 x 7/12) – (300 x 2/12) = 2,100 shares.

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

(a) equity shares issued in exchange for cash are included when cash is receivable;

(b) equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

Example : On 1st January 2015, X Ltd. had 1,00,000, 12% convertible debentures of ₹ 100 each. These debentures are due for conversion on 1st July, 2015. For every debenture 10 equity shares of ₹ 10 will be given.
These shares will be included in the Weighted Average Calculation from 1st July, 2015.

(c) equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

Example : Ram holds 10,000, 12% Debentures of ₹ 100 each of Rahim Ltd. The company is having cash flow problems.
Instead of receiving interest from April 1 to September 30, 2015 Ram will receive 6,000 equity shares of ₹ 10 each.
Ram will receive these shares on 15th October, 2015.
These shares will be included in the Weighted Average Calculation from 1st April, 2015 when interest ceased to accrue.

(d) equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

Example : The technical advisor of your company has agreed to receive shares in respect of his technical fees. The shares were issued on 1st July, 2015 — the date of settlement.
These shares will be included in the Weighted Average Calculation from 1st July, 2015.

(e) equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised;

Example : Your company, Modern Software Ltd. has acquired one office space by issuing 1,00,000 equity shares of ₹ 100 each of the company. The building has been recorded in the books of account on 1st April, 2015.
These shares will be included in the Weighted Average Calculation from 1st April, 2015.

(f) equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Example : In payment for fees, the legal advisor of the company agrees to receive shares. Though the services were rendered on 1st April, 2015 the company has issued equity shares in this respect on 1st August, 2015.
These shares will be included in the Weighted Average Calculation from 1st April, 2015 as the services were rendered. The actual date of issue of shares will not be taken into consideration.

Equity shares issued as part of the consideration in an amalgamation in ***the nature of purchase are included in the weighted average number of shares as of the date of the acquisition*** because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition.

Example : K Ltd. has taken over the business of P Ltd. on 1st July, 2015. It is an amalgamation in the nature of purchase. The accounting year of K Ltd. is 1st April to 31st March.
Purchase consideration was satisfied by issue of equity shares on 1st July, 2015.
These shares will be included in the calculation of weighted average from 1st July, 2015.

Equity shares issued during the reporting period as part of the consideration in an amalgamation in ***the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period*** because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period.

Example : K Ltd. has taken over the business of P Ltd. on 1st July, 2015. It is an amalgamation in the nature of merger.
The accounting year of K Ltd. is 1st April to 31st March. The purchase consideration was satisfied by issue of equity share of K Ltd. on 1st July, 2015.
These shares will be included in Weighted Average Calculation from 1st April, 2015 as it is an amalgamation in the nature of merger.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Example — Partly Paid Shares
(Accounting year 1-1-2014 to 31-12-2014)

		No. of Shares Issued	Nominal value of shares	Amount paid
1st January, 2014	Balance at beginning of year	1,800	₹ 10	₹ 10
31st Oct., 2014	Issue of Shares	600	₹ 10	₹ 5

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.
Computation of weighted average would be as follows : (1,800 x 12/12) + (300 x 2/12) = 1,850 shares.

Illustration 1

Compute Basic Earnings per Share from the following information :

Date	Particulars	No. of Shares
1st April, 2008	Balance at the beginning of the year	1,500
1st August, 2008	Issue of shares for cash	600
31st March, 2009	Buy back of shares	500

Net profit for the year ended 31st March, 2009 was ₹ 2,75,000. ***[C.A. (IPCC) — November, 2009]***

Solution

Basic Earnings per Share (EPS)

$$\frac{\text{Net Profit Attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares Outstanding during the year}} = \frac{2,75,000}{1,900} = ₹\ 144.74.$$

Working Note :

Statement Showing the Computation of Weighted Average Number of Equity Shares

Date	Number of Shares	Period Outstanding (Months)	Weights (Months))	Weighted Average Number of Shares
1st April, 2008	1,500 (opening balance)	12	12/12	1,500
1st August, 2008	600 (newly issued)	8	8/12	400
31st March, 2009	500 (buy back)	0	0/12	0
				1,900

Illustration 2

In April 2009 a limited company issued 1,20,000 equity shares of ₹ 100 each. ₹ 50 per share was called-up on that date which was paid by all shareholders. The remaining ₹ 50 was called-up on 1.9.2014. All shareholders paid the sum in September 2014, except one shareholder having 24,000 shares.

The net profit for the year-ended on 31.3.2010 is ₹ 2,64,000 after dividend on preference shares and dividend distribution tax of ₹ 64,000. Compute basic EPS for the year ended 31.3.2015 as per AS—20.

Solution

Basic Earnings Per Share (EPS)

$$= \frac{\text{Net Profit attributableto Equity Shareholders}}{\text{Weighted Average No. of Equity Shares outstanding during the year}}$$

$$= \frac{2,64,000}{88,000\ (\text{See Working Note})} = ₹\ 3$$

Working Note : As per para 19 of AS—20 : 'Earnings per Share', partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity shares during the reporting period.

Calculation of Weighted Average Number of Equity Shares

Date	Number of Shares	Normal Value of Shares (₹)	Amount Paid (₹)
1st April, 2014	1,20,000	100	50
1st September, 2014	96,000	100	100
	24,000	100	50

Computation of Weighted Average would be as follows :

(i) $1,20,000 \times \frac{1}{2} \times \frac{5}{12}$	25,000 shares
(ii) $96,000 \times \frac{7}{12}$	56,000 shares
(iii) $24,000 \times \frac{1}{2} \times \frac{7}{12}$	7,000 shares
	88,000 shares

Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

Example : The capital structure of X Ltd. is as follows :

1,00,000 equity shares of ₹ 10 each fully paid	₹ 10,00,000
1,00,000 equity shares of ₹ 20 each fully paid	₹ 20,00,000
Equivalent Number of Shares :	
1,00,000 of ₹ 10 each	1,00,000
(1,00,000 × 2) of ₹ 10 each	2,00,000
Equity Shares of ₹ 10 each	3,00,000

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Example : X Ltd. acquired a company in 2014. The company will issue more shares to the vendor in March, 2016 if the profit for calendar years 2014 and 2015 meet the target.
These additional shares will be included in the Weighted Average Calculation from 1st January, 2016 if the targets are met.

The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources.

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

(a) a bonus issue;

Example : The share capital of Avishek Ltd. consist of 40,000 equity shares of ₹ 10 each. The company issued one bonus share for every four shares held.
The number of bonus shares will be 10,000.

(b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

Example : If shareholders hold their shares for 4 years, they will receive one bonus share for every 5 shares held.

(c) a share split;

Example : Your company, R Limited is having 2,00,000 equity shares of ₹ 100 each. The market price is ₹ 2,000. The company has decided to change it to 20,00,000 equity shares of ₹ 10 each to make each share less expensive.

(d) a reverse share split (consolidation of shares).

Example : Your company, S Ltd. is having 20,00,000 equity shares of ₹ 1 each. The company has decided to change it to 2,00,000 equity shares of ₹ 10 each.

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no extra consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred ***at the beginning of the earliest period reported***. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Example — Bonus Issue

Net profit for the year 2014	₹ 18,00,000
Net profit for the year 2015	₹ 60,00,000
No. of equity shares outstanding until 30th September, 2015	20,00,000
Bonus issue 1st October 2015	2 equity shares for each equity share outstanding at 30th September, 2012 : 20,00,000 x 2 = 40,00,000.
Earnings per share for the year 2015	$\frac{60,00,000}{20,00,000 + 40,00,000}$ = ₹ 1
Adjusted earnings per share for the year 2014	$\frac{18,00,000}{20,00,000 + 40,00,000}$ = ₹ 0.30
Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2011, the earliest period reported.	

Illustration 3

The following are the details of equity share capital of X Limited for the year ended 31.12.2013 and 31.12.2014:

10,00,000 equity shares of ₹ 10 each fully paid up on 1.1.2013.

Issue of bonus shares made on 1.6.2014 in the ratio of 1 : 1.

Net profit after tax : 31.12.2013 — ₹ 45,00,000; 31.12.2014 — ₹ 60,00,000.

You are required to compute basic earnings per share.

Solution **Statement Showing Weighted Average Shares Outstanding**

Particulars	Date	Period Outstanding (years)	Weighted Average Number of Shares
Fully paid equity shares	1.1.2013	1	10,00,000
Issue of bonus shares (1 : 1)	1.6.2014	1	10,00,000
	Weighted Average Shares Outstanding on 2011 and 2012		20,00,000*

* Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2013, the earliest period reported.

Statement Showing Computation of Basic Earnings Per Share

Particulars	31.12.2013 ₹	31.12.2014 ₹
Net Profit after Tax (A)	45,00,000	60,00,000
Weighted Average Number of Equity Shares (as above) (B)	20,00,000	20,00,000
Basic Earnings per Share (A/B)	₹ 2.25	₹ 3.00

The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. ***In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following factor***:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex–right fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Example — Rights Issue

Net profit	2013 : 2014 :	₹ 11,00,000 ₹ 15,00,000
No. of equity shares outstanding prior to rights issue	5,00,000 shares	
Rights Issue	One new share for each five outstanding (i.e., 1,00,000 new shares) Rights Issue price : ₹ 15.00 Last date to exercise rights : 1st March, 2014	
Fair value of one equity share immediately prior to exercise of rights on 1st March, 2014	₹ 21.00	

Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair Value of all Outstanding Shares immediately prior to exercise of Rights + Total Amount Received from Exercise}}{\text{Number of Shares Outstanding Prior to Exercise + Number of Shares Issued in the Exercise}}$$

$$= \frac{(21.00 \times 5{,}00{,}000 \text{ shares}) + (15.00 \times 1{,}00{,}000 \text{ shares})}{5{,}00{,}000 \text{ shares} + 1{,}00{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = ₹ **20.00**.

Computation of adjustment factor

$$\frac{\text{Fair value per share prior exercise of rights}}{\text{Theoretical ex–rights value per share}} = \frac{21.00}{20.00} = 1.05$$

Computation of earnings per share		Year 2011	Year 2012
EPS for the year 2013 as originally reported: ₹ 11,00,000 / 5,00,000 shares		₹ 2.20	
EPS for the year 2013 restated for rights issue: ₹ 11,00,000 / (5,00,000 shares x 1.05)	2.10		
EPS for the year 2014 including effects of rights issue			₹ 2.55
$\frac{15{,}00{,}000}{(5{,}00{,}000 \times 1.05 \times 2/12) + (6{,}00{,}000 \times 10/12)}$			

Illustration 4

On 1.1.2013, X Limited had 1,00,000 equity shares of ₹ 10 each fully paid. On 1.7.2014, it issued rights shares to the existing shareholders in the ratio of 1 : 1 at a price of ₹ 20 each. The closing market price of the shares prior to the issue was ₹ 35. The basic reported EPS for the year ended 31.12.2013 was ₹ 2.20. The net profit after tax for the year ended 31st December were : 2013 — ₹ 2,20,000; 2014 — ₹ 2,40,000.

You are required to compute basic EPS.

Solution

Computation of Theoretical Ex Rights Price

$$\frac{\text{Fair Value of all Outstanding Shares immediately prior to exercise of Rights + Total Amount Received from Exercise}}{\text{Number of Shares Outstanding Prior to Exercise + Number of Shares Issued in the Exercise}}$$

$$= \frac{(1{,}00{,}000 \times 35) + (1{,}00{,}000 \times 20)}{1{,}00{,}000 + 1{,}00{,}000} = ₹\ 27.50.$$

Therefore, the theoretical ex-rights price is ₹ 27.50.

Computation of Adjustment Factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex–rights value per share}} = \frac{35}{27.50} = 1.27$$

Therefore, the adjustment factor is 1.27.

Computation of Earnings Per Share

Particulars	31.12.2013 ₹	31.12.2014 ₹
EPS for the year 2013 (as given)	2.20	
EPS for the year 2013 restated for rights issue = $\frac{\text{Rs } 2{,}20{,}000}{(1{,}00{,}000 \text{ shares} \times 1.27)}$	1.73	
EPS for the year 2014 including effects of rights issue = $\frac{2{,}40{,}000}{(1{,}00{,}000 \times 1.27 \times 6/12) + (2{,}00{,}000 \times 6/12)}$		1.47

Illustration 5

The following information is available for Raja Ltd for the accounting year 2009-10 and 2010-11.

Net Profit for : 2009-10 — ₹ 25,00,000; 2010-11 — ₹ 40,00,000.

Number of shares outstanding prior to right issue — 12,00,000 shares.

Rights Issue : One new share for each three outstanding, i.e., 4,00,000 shares.

Rights issue price ₹ 22.

Last date to exercise rights — 30.6.2010.

Fair value of one equity share immediately prior to exercise of rights on 30.6.2010 is ₹ 28.

You are required to compute the basic earnings per share for the years 2009-10 and 2010-11.

[C.A. (IPCC) — May, 2012]

Solution

Computation of Basic Earnings per Share for 2009-10

(i) EPS for the year 2009-10 as originally reported :

$$\frac{\text{Net Profit for the year attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares Outstanding during the year}}$$

$$= \frac{25{,}00{,}000}{12{,}00{,}000 \text{ shares}} = ₹\ \mathbf{2.08}.$$

(ii) EPS for the year 2009-10 re-stated for Rights Issue :

$$\frac{\text{Net Profit for the year attributable to Equity Shareholders}}{(\text{Weighted Average Number of Equity Shares Outstanding prior to Rights Issue}) \times \text{Adjustment Factor}}$$

$$= \frac{25{,}00{,}000}{12{,}00{,}000 \times 1.06 \text{ (Note 2)}} = ₹\ 1.97 \text{ (approx)}.$$

Computation of Basic Earnings per Share Share for the year 2010-11

$$\frac{\text{Net Profit for the year attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares Outstanding during the year}}$$

$$= \frac{40{,}00{,}000}{(12{,}00{,}000 \times 1.06 \times 3/12) - (16{,}00{,}000 \times 9/12)} = ₹\ \mathbf{2.64}.$$

Working Notes :

(1) Computation of Theoretical Ex-Rights Price

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

$$= \frac{(28 \times 12{,}00{,}000 \text{ shares}) + (22 \times 4{,}00{,}000 \text{ shares})}{12{,}00{,}000 \text{ shares} + 4{,}00{,}000 \text{ shares}}$$

$$= \frac{3{,}36{,}00{,}000 + 88{,}00{,}000}{16{,}00{,}000 \text{ shares}} = \frac{4{,}24{,}00{,}000}{16{,}00{,}000 \text{ shares}} = ₹\ \mathbf{26.50}.$$

(2) Computation of Adjustment Factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex–right value per share}} = \frac{28}{26.50} = ₹\ \mathbf{1.06} \text{ (approx.)}$$

Illustration 6

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

[Accounting Year : 1.1.2013 – 31.12.2013]

(i) Net Profit = Year 2013 — ₹ 20,00,000; Year 2014 — ₹ 30,00,000.

(ii) Number of Shares outstanding prior to rights issue — 10,00,000 Shares

(iii) Rights Issue — (a) One new share for each four outstanding, i.e., 2,50,000 shares.

(b) Rights issue price — ₹ 20.

(c) Last date of exercising of rights — 31.3.2014.

(iv) Fair rate of one equity share prior to exercise of rights on 31.3.2014 — ₹ 25.

Solution

Computation of Theoretical Ex-Rights Price

$$\frac{\text{Fair Value of all Outstanding Shares immediately prior to exercise of Rights + Total Amount Received from Exercise}}{\text{Number of Shares Outstanding Prior to Exercise + Number of Shares Issued in the Exercise}}$$

$$= \frac{(10{,}00{,}000 \times 25) + (2{,}50{,}000 \times 20)}{10{,}00{,}000 + 2{,}50{,}000 \text{ Shares}} = \frac{3{,}00{,}00{,}000}{12{,}50{,}000 \text{ Shares}} = ₹\ 24$$

Therefore, theoretical ex-rights price is ₹ 24.

Computation of Adjustment Factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex–rights value per share}} = \frac{25}{24} = 1.04 \text{ (approx.)}$$

Computation of Earnings Per Share

Particulars	2013 ₹	2014 ₹
1. EPS for the year 2013 — $\frac{20{,}00{,}000}{10{,}00{,}000}$	2.00	—
2. EPS for the year 2013 re-stated for rights issue = $\frac{20{,}00{,}000}{(10{,}00{,}000 \times 1.04)}$	1.92	—
3. EPS for 2008 including effects of rights issue = $\frac{30{,}00{,}000}{(10{,}00{,}000 \times 1.04 \times 3/12) + (12{,}50{,}000 \times 9/12)}$	—	2.51 (app.)

Illustration 7

On 1.1.2013, X Limited had 1,00,000 equity shares of ₹ 10 each fully paid. On 1.7.2014, X Limited bought back 20% of its paid-up equity share capital @ ₹ 40 per share. Prior to the buy back, the market price of each equity share was ₹ 25. The net profits after tax for the year 2013 and 2014 were ₹ 2,00,000 and ₹ 2,50,000 respectively. You are required to calculate EPS.

Solution **Calculation of Theoretical Ex-buy Back Price**

Particulars			₹
Fair value of 1,00,000 equity shares before buy back (1,00,000 x ₹ 25)			25,00,000
Less: Proceeds of buy back (20,000 x ₹ 40)			8,00,000
		(A)	17,00,000
Number of outstanding shares before buy back	Nos.		1,00,000
Number of shares bought back		"	20,000
Number of shares outstanding after buy back		(B)	80,000

$$\text{Therefore, theoretical ex-buy back price} = \frac{17,00,000}{80,000} = 21.25$$

$$\text{Buy-back adjustment factor is} = \frac{40}{21.25} = 1.88$$

Computation of Earnings Per Share

Particulars	2011	2012
Profit after tax (₹)	2,00,000	2,50,000
Number of equity shares outstanding	1,00,000	80,000
Weighted average number of equity shares	1,00,000	*1,34,000
Earning per share (₹)	2	—
Adjusted earning per share (₹)	**1.06	***1.86

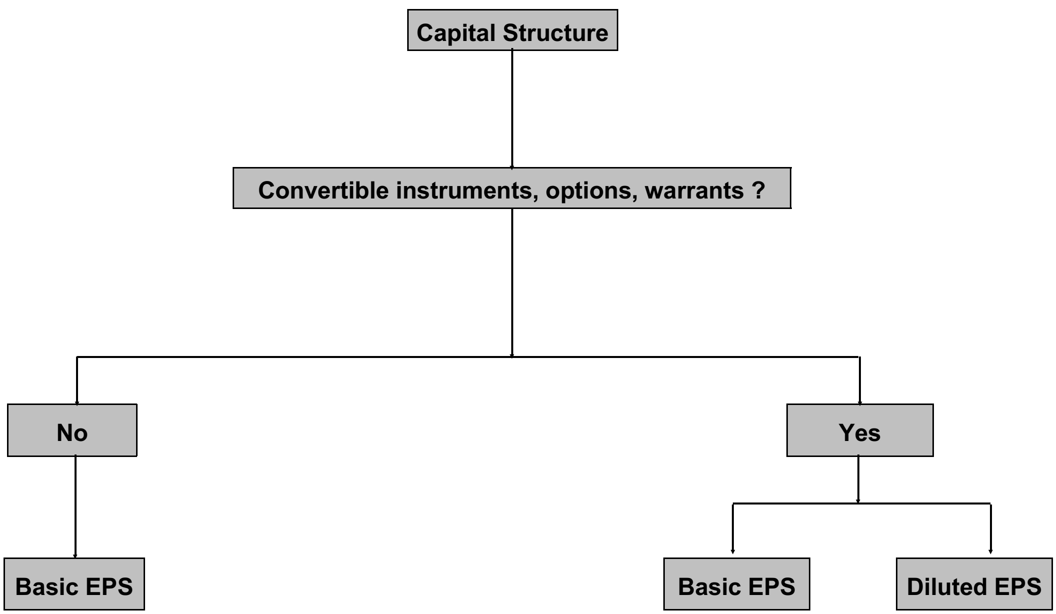
$*(1,00,000 \times 1.88 \times 6/12) + (80,000 \times 6/12)$ $\quad **\frac{2}{1.88}$ $\quad ***\frac{2,50,000}{1,34,000}$

Diluted Earnings Per Share

Dilution is the reduction in earning per share (or increase in net loss per share) resulting from the assumption that convertible instruments are converted, that options and warrants are exercised, or that shares are issued upon the satisfaction of the specified conditions.

If there is ***no potential shares outstanding***, there will be ***no diluted earnings per share***.

If there is ***potential shares outstanding***, the computation of diluted earnings per share will be required, wherever basic earnings per share is presented. The following diagram will show it :



Example : X Ltd. is having 10,00,000 equity shares of ₹ 10 each. The company is also having 1,00,000, 10% convertible debentures of ₹ 100 each.
Each debenture will be convertible into 10 shares. Net profit for the period is ₹ 75,00,000. Rate of tax is 30%.

Basic earnings per share = $\frac{75,00,000}{10,00,000}$ = **₹ 7.50**

To calculate the diluted earnings per share the following adjustment is necessary :

(1) Add back the cost of interest on debentures, net of tax
1,00,000 × ₹ 100 × 10% (100% – 30%) = ₹ 7,00,000.

Net profit after adjustment of debenture interest
= ₹ 75,00,000 + ₹ 7,00,000 = ₹ 82,00,000.

(2) Add the number of new shares that would be issued, if all debentures are converted to current number of shares : 10,00,000 + (1,00,000 × 10) = 20,00,000

(3) Divide the revised net profit by revised number of shares : $\frac{82,00,000}{20,00,000}$ = **₹ 4.10**

***Effect* : If the debentures are converted today, EPS would fall from ₹ 7.50 to ₹ 4.10. Total earnings would rise because of savings in interest on debentures but the number of shares will be doubled. The existing shareholders will get less than what they are getting currently.**

For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

(a) the net profit for the period attributable to equity shares is:
   (i) increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;
   (ii) increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and
   (iii) adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

Example : X Ltd. is having 10,00,000 equity shares of ₹ 10 each. The company is also having 50,000, 10% convertible preference shares of ₹ 10 each. Convertion ratio is 1 : 1.
Profit after preference dividend is ₹ 80,00,000.

Basic earnings per share = $\frac{80,00,000}{10,00,000}$ = **₹ 8.**

To calculate diluted earnings per share, the following adjustments are necessary :

1. Add back preference dividend :
50,000 × ₹ 10 × 10% = ₹ 50,000.
Profit after adjusting preference dividend is ₹ 80,50,000 (₹ 80,00,000 + ₹ 50,000).

2. Add the number of new shares that would be issued, if all preference shares were converted, to the current number of shares :
10,00,000 + 50,000 × 1 = 10,50,000.

3. Divide the revised profit by the revised number of shares :
$\{\frac{80,50,000}{10,50,000}$ = **₹ 7.67**

***Effect* : The preference shares may be converted into equity shares in future. If they are converted today, EPS would fall from ₹ 8 to ₹ 7.67 per share. The existing shareholders' get less than what they are getting currently.**

(b) the weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Illustration 8

Net profit for the current year : ₹ 2,00,00,000.

Number of equity shares outstanding : 1,00,00,000.

Basic earnings per share : ₹ 2.00

Number of 12% convertible debentures of ₹ 100 each : 2,00,000

Each debenture is convertible into 10 equity shares. Interest expense for the current year : ₹ 24,00,000. Tax related to interest expense (30%) : ₹ 7,20,000.

Compute Diluted Earnings Per Share.

[C.A. (PCC) — May, 2012]

Solution **Calculation of Adjusted Net Profit**

Particulars		₹
Net Profit for the current year		2,00,00,000
Add: Interest expense for the current year	24,00,000	
Less: Tax relating to interest expense (30%)	7,20,000	16,80,000
Adjusted Net Profit for the current year		2,16,80,000

Calculation of Number of Potential Equity Shares

Particulars	Number
Number of Equity Shares Outstanding	1,00,00,000
Add: Number of Equity Shares resulting from Conversion of Debentures	20,00,000
Number of Potential Equity Shares	1,20,00,000

$$\text{Diluted Earnings Per Share} = \frac{\text{Adjusted Net Profit for the year}}{\text{Number of Potential Equity Shares}}$$

$$= \frac{2,16,80,000}{1,20,00,000} = \textbf{₹ 1.81 (approx.)}$$

Earnings - Diluted

For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

X Ltd.
Example — Convertible Debentures

Net profit for the current year	₹ 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	₹ 2.00
No. of 12% convertible debentures of ₹ 100 each Each debenture is convertible into 10 equity shares	1,00,000
Interest expense for the current year	₹ 12,00,000
Tax relating to interest expense (30%)	₹ 3,60,000
Adjusted net profit for the current year	₹ (1,00,00,000 + 12,00,000 – 3,60,000) = ₹ 1,08,40,000
No. of equity shares resulting from conversion of debentures	10,00,000
No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 = 60,00,000
Diluted earnings per share	1,08,40,000 / 60,00,000 = Re 1.81

The conversion of some potential equity shares may lead to consequential changes in other items of income or expense. For example, the reduction of interest expense related to potential equity shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit sharing plan. For the purpose of calculating diluted earnings per share, the net profit or loss for the period is adjusted for any such consequential changes in income or expenses.

Example : As per profit sharing plan, the employees of X Ltd. will get 5% of the net profit after tax, as calculated for basic earnings per share or diluted earnings per share, whichever is lower.
Using the previous example, diluted earnings per share are lower, so the calculation will be :
5% of ₹ 1,08,40,000 = ₹ 5,42,000.

The revised diluted earnings per share would be $= \dfrac{1,08,40,000 - 5,42,000}{60,00,000} =$ **₹ 1.72**

Basic earnings are 1,00,00,000. 5% would yield = ₹ 5,00,000.

The revised basic earnings per share would be $= \dfrac{1,00,00,000 - 5,00,000}{50,00,000} =$ **₹ 1.90.**

Per Share - Diluted

For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares, plus the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares.

Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Example : In 2012, X Ltd. issued 1,00,000, 10% convertible preference shares of ₹ 100 each. As per terms and conditions in 2015 holders may convert their shares into cash @ ₹ 130 or alternatively for one equity share of ₹ 100 each. Shares were trading on the Balance Sheet date (31.12.2014) @ ₹ 150 each.
For calculation, it should be assumed that the holder of preference shares will choose to convert to equity shares, rather than to cash.

Contingently-Issuable Shares

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met.

If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later).

The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period.

Example : In 2013, your company P Ltd. issued employee stock options for 1,00,000 shares that can be exercised if profits for the year 2014, 2015 and 2016 cross by more than 5% each year.

For diluted earnings per share these are treated as contingently issuable shares.

At the end of 2013, the company added 1,00,000 shares to the weighted average figure, as if these shares have been issued on 31st December, 2013.

At end of 2014, the net profit target has not been met. Therefore, the shares are cancelled on 31st December, 2014. The figures for 2012 are not restated.

For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

Fair value for this purpose is the average price of the equity shares during the period. Theoretically, every market transaction for an enterprise's equity shares could be included in determining the average price. As a practical matter, however, a simple average of last six months weekly closing prices are usually adequate for use in computing the average price.

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

(a) a contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

(b) a contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Example — Effects of Share Options on Diluted Earnings Per Share

Net profit for the year 2013	₹ 12,00,000
Weighted Average Number of Equity Shares Outstanding during the year 2013	5,00,000 shares
Average Fair Value of one equity share during the year 2013	₹ 20.00
Weight Average Number of shares under option during the year 2013	1,00,000 shares
Exercise price for shares under option during the year 2013	₹ 15.00

Computation of earnings per share

	Earnings	Shares	Earnings per Share
Net profit for the year 2013	₹ 12,00,000		
Weighted average number of shares outstanding during year 2013		5,00,000	
Basic earnings per share			₹ 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value : (1,00,000 x 15.00) / 20.00	*	(75,000)	
Diluted earnings per share	₹ 12,00,000	5,25,000	₹ 2.29
* The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration			

To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

Dilutive Potential Equity Shares

Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

Example : The basic earnings per share = 1.90.
The diluted earnings per share = 1.72. (See example of Profit Sharing Plan of X Ltd.)
The conversion will be diluted as the equity shareholders would see their earnings per share fall.

An enterprise uses net profit from continuing ordinary activities as "the control figure" that is used to establish whether potential equity shares are dilutive or anti-dilutive. The net profit from continuing ordinary activities is the net profit from ordinary activities (as defined in AS 5) after deducting preference dividends and any attributable tax thereto and after excluding items relating to discontinued operations.

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

Example : K Ltd. issued 10,00,000 equity shares of ₹ 100 each. The company also issued 10,00,000, 10% Convertible Debentures of ₹ 100 each. Conversion ratio is 1 : 1.
Net profit for the year = ₹ 50,00,000.
Rate of tax is 30%.

Basic Earnings per Share $= \dfrac{50,00,000}{10,00,000} = 5$

Diluted Earnings per Share $= \dfrac{50,00,000 + 70,00,000*}{20,00,000} =$ **₹ 6**

*** 10,00,000 × ₹ 100 × 10% (100% – 30%) = ₹ 70,00,000.**
Effect : If the debentures are converted today, EPS would increase from ₹ 5 to ₹ 6 which would be anti-dilutive. These will not be included in the diluted earnings per share.

In considering whether potential equity shares are dilutive or anti-dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Example — Determining the Order in which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares

Earnings, i.e., Net profit attributable to equity shares	₹ 1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	₹ 75.00
Potential Equity Shares	
Options	1,00,000 with exercise price of ₹ 60.
Convertible Preference Shares	8,00,000 shares entitled to a cumulative dividend of ₹ 8 per share. Each preference share is convertible into 2 equity shares.
Attributable tax, e.g., corporate dividend tax	10%
12% Convertible Debentures of ₹ 100 each	Nominal amount ₹ 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax rate	30%

Increase in Earnings Attributable to Equity Shareholders on Conversion of Potential Equity Shares

	Increase in Earnings	Increase in Number of Equity Shares	Earnings per Incremental Share
Increase in Earnings	Nil		
No. of incremental shares issued for no consideration [1,00,000 x (75 – 60) / 75]		20,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable tax [(₹ 8 x 8,00,000) + 10% (8 x 8,00,000)]	₹ 70,40,000		
No. of incremental shares (2 x 8,00,000)		16,00,000	₹ 4.40
12% Convertible Debentures			
Increase in net profit [₹ 10,00,00,000 x 0.12 x (1 – 0.30)]	₹ 84,00,000		
No. of incremental shares (10,00,000 x 4)		40,00,000	₹ 2.10

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered.

Computation of Diluted Earnings Per Share

	Net Profit Attributable (₹)	No. of Equity Shares	Net Profit Attributable Per Share (₹)	
As reported	1,00,00,000	20,00,000	5.00	
Options		20,000		
	1,00,00,000	20,20,000	4.95	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	60,20,000	3.06	Dilutive
Convertible Preference Shares	70,40,000	16,00,000		
	2,54,40,000	76,20,000	3.34	Anti-Dilutive

Since dilutive earnings per share is increased when taking the convertible preference shares into account (from ₹ 3.06 to ₹ 3.34), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is ₹ 3.06.

Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

Illustration 9

On 1.1.2015, X Limited had 1,00,000 equity shares of ₹ 10 each and 20,000, 10% fully convertible debentures of ₹ 100 each. Each convertible debenture is converted into 8 equity shares of ₹ 10 each fully paid. The net profit after tax of the company is ₹ 6,00,000. Calculate basic and diluted earning per share assuming income tax rate is @ 35%. Assume that the debentures are converted at the beginning of the year.

Solution

Net Profit for the current year	₹ 6,00,000
Number of equity shares outstanding	1,00,000
Basic earnings per share (₹ 6,00,000 / 1,00,000)	₹ 6
Number of 10% fully convertible debentures	20,000
Interest expense for the current year (10% on ₹ 20,00,000)	₹ 2,00,000
Tax relating to interest expense (35% on ₹ 2,00,000)	₹ 70,000
Adjusted net profit for the current year (₹ 6,00,000 + 2,00,000 – 70,000)	₹ 7,30,000

Number of equity shares resulting from conversion (20,000 × 8)	1,60,000
Number of equity shares used to compute diluted earnings per share (1,00,000 + 1,60,000)	2,60,000
Diluted earnings per share (₹ 7,30,000 / 2,60,000)	₹ 2.81

Illustration 10

From the books of Bharati Ltd., following are available as on 1.4.2013 and 1.4.2014.

(1)	Equity shares of ₹ 10 each	1,00,000
(2)	Partly paid equity shares of ₹ 10 each — ₹ 5 paid	1,00,000
(3)	Options outstanding at an average exercise price of ₹ 60 per one equity share of ₹ 10 each. Average fair value of equity share during both years ₹ 75	10,000
(4)	10% convertible preference shares of ₹ 100 each. Conversion ratio 2 equity shares for each preference share.	80,000
(5)	12% convertible debenture of ₹ 100 each. Conversion ratio 4 equity shares for each debenture.	10,000
(6)	10% dividend tax is payable for the years ending 31.3.2015 and 31.3.2014.	
(7)	On 1.10.2014, the partly paid shares were fully paid up.	
(8)	On 1.10.2015, the company issued 1 bonus share for 8 shares held on that date.	

Net Profit available to the equity shareholders for the years ending :

31.3.2015 and 31.3.2014 were ₹ 10,00,000.

Calculate :

(i) Earnings per share for years ending 31.3.2015 and 31.3.2014.

(ii) Diluted earnings per share for years ending 31.3.2015 and 31.3.2014.

(iii) Adjusted earnings per share and diluted EPS for the year ending 31.3.2014, assuming the same information for previous year, also assume that partly paid shares are eligible for portionate dividend only. Assume tax rate of 30% and corporate dividend tax of 10%.

Solution

(i) Computation of EPS for years ending 31.3.2014 and 31.3.2015

Particulars	31.3.2012	31.3.2013
Net Profits attributable to equity shares (A)	₹ 10,00,000	₹ 10,00,000
Weighted Average number of equity shares (B)	1,75,000*	2,00,000*
Earnings per share	₹ 5.71	₹ 5.00
*** Calculation of Weighted Average Number of Equity Shares**		
Fully paid equity shares	1,00,000	1,00,000
Partly paid equity shares	50,000	—
(a) 1,00,000 partly paid equity shares for 6 months (1,00,000 × 1/2 × 6/12)	—	25,000
(b) 1,00,000 fully paid shares for remaining 6 months (1,00,000 × 6/12)	—	50,000
(c) Bonus shares (2,00,000 × 1/8)	25,000	25,000
Weighted average number of equity shares	1,75,000	2,00,000

Note: Bonus shares were issued on 1.1.2015, by that date all the partly paid shares were made fully paid. In effect, bonus shares were given to all 2,00,000 shares. Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of 1.4.2014, the earlier period reported.

(ii) Computation of Diluted EPS for Potential Equity Shares and Ranking

Particulars	Options	Convertible Preference Shares	12% Convertible Debentures
Total earnings (A)	Nil	₹ 8,80,000*	₹ 84,000**
Increase in number of equity shares (B)	10,000***	1,60,000 (2 x 80,000)	40,000 (4 x 10,000)
Incremental EPS (A/B)	Nil	₹ 5.50	2.10
Rank	1	3	2

* Savings of dividend + savings of corporate dividend tax = ₹ 8,00,000 + 10% of ₹ 8,00,000 = ₹ 8,80,000.

** Savings of interest – Tax relating to interest = 1,20,000 – 30% of ₹ 1,20,000 = ₹ 84,000.

*** Options issued for no consideration = (2,000 × (75 – 60) / 75) = 10,000.

Computation of Diluted EPS

Particulars	Original Shares		Options		Debentures		Preference Shares	
	2014	2015	2014	2015	2014	2015	2014	2015
Number of shares	1,50,000	2,00,000	1,52,000	2,02,000	1,92,000	2,42,000	3,52,000	4,02,000
Profit attributable	10,00,000	10,00,000	10,00,000	10,00,000	10,84,000	10,84,000	19,64,000	19,64,000
EPS	6.67	5.00	6.58	4.94	5.65	4.48	5.58	4.89
Nature of EPS	Basic	Basic	Dilutive	Dilutive	Dilutive	Dilutive	Dilutive	Anti-Dilutive

When convertible preference shares are taken into account for the year 2014-15, diluted EPS is increased. But the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted EPS for 2014-15. In effect, diluted EPS for 2014-15 is taken as ₹ 4.48. However, for 2013-14, the convertible preference shares are dilutive and, therefore, these are taken into account in the calculation of diluted EPS. Accordingly, diluted EPS for the year ended 31.3.2014 is ₹ 5.58.

(iii) Computation of Adjusted EPS

Net profit attributable to equity shareholders (A)	₹ 10,00,000
Weighted average number of equity shares (B)	1,75,000
Adjusted EPS (A/B)	₹ 5.714

Computation of Adjusted Diluted EPS

Particulars	Net Profit	Number of Shares	Earnings Per Share
Options	10,00,000	1,77,000 (1,75,000 + 2,000)	5.65 (Dilutive)
12% Convertible Debentures	10,84,000 (10,00,000 + 84,000)	2,17,000 (1,77,000 + 40,000)	5.00 (Dilutive)
10% Convertible Preference Shares	19,64,000 (10,84,000 + 8,80,000)	3,77,000 (2,17,000 + 1,60,000)	5.21 (Anti-dilutive)

Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

An enterprise does not restate diluted earnings per share of any prior period presented for changes in the assumptions used or for the conversion of potential equity shares into equity shares outstanding.

An enterprise is encouraged to provide a description of equity share transactions or potential equity share transactions, other than bonus issues, share splits and reverse share splits (consolidation of shares) which occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. Examples of such transactions include:

(a) the issue of shares for cash;

(b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;

(c) the cancellation of equity shares outstanding at the balance sheet date;

(d) the conversion or exercise of potential equity shares, outstanding at the balance sheet date, into equity shares;

(e) the issue of warrants, options or convertible securities; and

(f) the satisfaction of conditions that would result in the issue of contingently issuable shares.

Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because such transactions do not affect the amount of capital used to produce the net profit or loss for the period.

Disclosure

In addition to disclosures as required by paragraphs 8, 9 and 44 of this Statement, an enterprise should disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies), the enterprise should disclose basic and diluted earnings per share computed on the basis of earnings excluding extraordinary items (net of tax expense); and

(ii) (a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(b) the weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(c) the nominal value of shares along with the earnings per share figure.

Contracts generating potential equity shares may incorporate terms and conditions which affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether or not any potential equity shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the net profit attributable to equity shareholders. Disclosure of the terms and conditions of such contracts is encouraged by this Statement.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

An enterprise may wish to disclose more information than this Statement requires. Such information may help the users to evaluate the performance of the enterprise and may take the form of per share amounts for various components of net profit. Such disclosures are encouraged. However, when such amounts are disclosed, the denominators need to be calculated in accordance with this Statement in order to ensure the comparability of the per share amounts disclosed.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Readers of financial statements use EPS data in evaluating
   A the financial health of the enterprise
   B efficiency of inventory management
   C operating performance of the enterprise
2. An enterprise should present basic and diluted earnings per share
   A on the face of the balance sheet
   B on the face of the profit and loss account
   C in directors' report
3. Dilution is
   A the reduction in the earnings per share
   B the increase in the earnings per share
   C the reduction in net loss per share
4. Diluted earnings per share is required when
   A there is long-time loan in the balance sheet of the company
   B an acquisition has been made
   C there are potential shares outstanding

5. Equity Shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares
   A as of the date of acquisition
   B from the beginning of reporting period
   C from the middle of the reporting period
6. Basic earnings per share amounts uses the net profit attributable to
   A both equity and preference shareholders
   B equity shareholders only
   C preference shareholders only
7. Equity Shares issued during the reporting period as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares
   A from the date of merger
   B from the beginning of reporting period
   C from the middle of the reporting period
8. Equity Shares issued in exchange for the settlement of a liability of the enterprise are included in the EPS calculation from
   A the date of contract for service
   B the date of settlement become effective
   C the date of completion of service
9. Contingently - issuable shares are treated as outstanding and are included in the calculation of basic earnings per share
   A from the date of contract
   B from the date when new shares are registered
   C from the date when the conditions under the contract are met
10. X Ltd. has issued some high interest debentures, which will be anti-dilutive if converted. These will be included in the calculation of
   A basic earnings per share
   B dilutive earnings per share
   C neither

PRACTICAL QUESTIONS

1. Ram Ltd had 12,00,000 equity shares on April 1, 2011. The company earned a profit of ₹ 30,00,000 during the year 2011-12. The average fair value per share during 2011-12 was ₹ 25. The company has given share option to its employees of 2,00,000 equity shares at option price of ₹ 15.
   Calculate basic EPS and diluted EPS. ***[C.A. (IPCC) — Adapted]***
2. (i) Explain the concept of weighted average number of equity shares outstanding during the period. State how would you compute based on AS-20 the weighted average number of equity shares in the following cases :

		No. of Shares
1st April, 2011	Balance of Equity Shares	4,80,000
31st August, 2011	Equity Shares issued for cash	3,60,000
1st February, 2012	Equity Shares bought back	1,80,000
31st March, 2012	Balance of Equity Shares	6,60,000

   (ii) Compute adjusted earning per share and basic earning per share based on the following information:
   Net Profit — 2010-11 : ₹ 11,40,000
   Net Profit — 2011-12 : ₹ 22,50,000
   Number of equity shares oustanding until 31st December, 2011: ₹5, 00,000
   Bonus issue on 1st January, 2012 — 1 equity share for each equity share outstanding as at 31st December, 2011.

[C.A. (IPCC) — Adapted]

Guide to Answers

Multiple Choice

1. C; **2.** B; **3.** A; **4.** C; **5.** A; **6.** B; **7.** B; **8.** B; **9.** C; **10.** C

Practical Questions

1. (i) Basic Earnings Per Share = ₹ 2.50.
   (ii) Diluted Earnings Per Share = ₹ 2.34
2. (i) Weighted average number of equity shares : 6,60,000.
   (ii) Earning per share :
      (a) Basic EPS 2010-11 — ₹ 2.28
      (b) Basic EPS 2011-12 — ₹ 2.25
      (c) Adjusted EPS 2010-11 — ₹ 1.14

AS — 26 : Intangible Assets
[Effective Date : 1st April, 2008]

Introduction

An intangible asset is a long-term asset without physical substance held for use in the business. Its value comes from the long-term rights or advantage that will flow to the owner. Examples are patents, copyrights, trademarks, licences, franchises, formulas and goodwill etc.

In the past, intangible assets have not been considered very significant for financial reporting. Recently, interest in intangible assets has grown because companies are paying huge amount for acquiring such assets. (For example, many new mobile telephone companies are ready to pay ₹ 200-300 crores for obtaining licence from the government). In the past, the value of different intangible assets used to increase gradually as a company prospered. Nowadays, many intangible assets are purchased / developed for high prices. This includes not only traditional intangible assets, e.g., copyrights or trademarks, but also newer assets like mobile telephone licences, takeoff and landing rights at airports etc.

The growing financial significance of intangible assets has increased their importance as an accounting issue.

On the background of the above, the Council of Institute of Chartered Accounts of India issued AS—26: 'Intangible Assets' in 2007. It is effective from 1st April, 2008 and mandatory in nature from that date for the following :

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India;
(ii) Enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard;
(iii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores;

Objectives

The objective of this Statement is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. This Statement requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Statement also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

Scope

This Statement should be applied by all enterprises in accounting for intangible assets, except:

(a) intangible assets that are covered by another Accounting Standard;
(b) financial assets;
(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and
(d) intangible assets arising in insurance enterprises from contracts with policyholders.

If another Accounting Standard deals with a specific type of intangible asset, an enterprise applies that Accounting Standard instead of this Statement. For example, this Statement does not apply to:

(a) intangible assets held by an enterprise for sale in the ordinary course of business (see AS—2, Valuation of Inventories, and AS—7, Accounting for Construction Contracts);
(b) deferred tax assets (see AS—22, Accounting for Taxes on Income);
(c) leases that fall within the scope of AS—19, Leases; and
(d) goodwill arising on an amalgamation (see AS—14, Accounting for Amalgamations) and goodwill arising on consolidation (see AS—21, Consolidated Financial Statements).

Definitions

Intangible Asset

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.

Asset

An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.

Monetary Asset

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Non-monetary Asset

Non-monetary assets are assets other than monetary assets.

Research

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

Amortisation

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciable Amount

Depreciable amount is the cost of an asset less its residual value.

Useful Life

Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

Residual Value

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Fair Value

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Active Market

An active market is a market where all the following conditions exist:

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

Impairment Loss

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Carrying Amount

Carrying amount is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

Intangible Assets

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as

- scientific or technical knowledge;
- design and implementation of new processes or systems;
- licences;
- intellectual property;
- market knowledge and trademarks (including brand names and publishing titles).

Common example of items encompassed by these broad headings are :

- Computer software
- Patents
- Copyrights
- Motion picture films
- Customer lists
- Mortgage servicing rights
- Fishing licences
- Import quotas
- Franchises
- Customer or supplier relationships
- Customer loyalty
- Market share and marketing rights

Not all the items described above will meet the definition of an intangible asset—(i) identifiability, (ii) control over a resource and (iii) expectation of future economic benefits flowing to the enterprise.

If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the ***nature of purchase***, it forms part of the goodwill recognised at the date of the amalgamation.

Identifiability

The definition of an intangible asset requires that the ***asset be identified***, to distinguish it from goodwill.

Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

Example: Your company B Chini Ltd. will be benefitted from the construction of a road through its sugar cane fields, but the company do not control it, unless it can restrict the access of others to the road.

The capacity of an enterprise to control these benefits would normally stem from legal rights, though an enterprise may be able to control the benefits in other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

Personnel do not usually meet the definition of an intangible asset because an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff.

For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the:

(a) definition of an intangible asset

(b) recognition criteria

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.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

An intangible asset should be measured initially ***at cost***.

Separate Acquisition

If an enterprise acquires intangible assets separately, or in amalgamation or through government grant, there is no restriction in recognising them. These should be recognised at cost.

The cost of an intangible asset comprises :

(i) purchase price

(ii) import duties

(iii) non-refundable other taxes

(iv) any directly attributable expenditure on making the assets ready for its intended use

(v) professional fees for legal services.

Any trade discounts and rebates are ***deducted*** in arriving at the cost.

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.

Example: HPCL issued 1,00,000 shares of ₹ 10 each to buy a patent right from RPL. The market value of the shares on the date of contract is ₹ 15,00,000. The fair value of the patent right is deemed to be ₹ 15,00,000.

Acquisition as Part of an Amalgamation

If an intangible asset is acquired in an amalgamation in the nature of purchase, the cost of that intangible asset is its fair value at acquisition.

Judgement is required to determine whether the cost (i.e. fair value) can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price.

If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets.

Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. They base fair value on-discounted revenue, market share, operating profit, etc. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase

Recognition of Identifiable Intangible Assets

(a) a transferee recognises an intangible asset that meets the recognition criteria
(b) if cost cannot be measured reliably, that intangible asset is not recorded separately but is included in goodwill

Example: Fair value of identifiable asset is ₹ 10,00,000, excluding an intangible asset. The purchase consideration has been agreed at ₹ 12,00,000. It is not possible to measure the cost of the intangible asset reliably.
Here, the intangible asset will not be recorded separately but will be included in the goodwill of ₹ 2,00,000 (₹ 12,00,000 – ₹ 10,00,000.

Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Example: Fair value of identifiable asset is ₹ 12,00,000 including an intangible asset. The purchase consideration has been agreed at ₹ 10,00,000. There is no active market for the intangible asset but management's estimate of fair value is ₹ 3,00,000. The capital reserve ignoring adjustment for intangible asset is ₹ 2,00,000.
Here, the intangible asset should be recognised at ₹ 1,00,000 (₹ 3,00,000 – ₹ 2,00,000). No capital reserve will be shown in the Balance Sheet.

Acquisition by Way of a Government Grant

An intangible asset acquired free of charge, or for nominal consideration by way of government grant is recognised

(i) at a nominal value; or
(ii) at the acquisition cost, as appropriate.

Any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Examples are : airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

Illustration 1

Government of Kerala has given fishing licence to AC Ltd. at a nominal price of ₹ 10,000. The current market price of the licence is ₹ 1,00,000. An expenditure of ₹ 25,000 was incurred by the company in relation to fishing licence. At what value should the licence be recorded in the books ?

Solution

An intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recorded at :

(i) a nominal value; or

(ii) the acquisition cost plus directly attributable cost.

Therefore, in the present case, the intangible asset should be recognised at ₹ 35,000 (₹ 10,000 + ₹ 25,000).

Exchange of Assets

An intangible asset may be acquired in exchange or part exchange of another asset. In such a case, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up.

Example: Your company TMH Ltd. can pay ₹ 5,00,000 in cash and give up a flat with a carrying value of ₹ 10,00,000 for acquiring copyright of a book. If the copyright cannot be measured at fair value, its cost should be taken at ₹ 15,00,000 (₹ 5,00,000 + ₹ 10,00,000).

Internally Generated Goodwill

Internally generated goodwill should not be recognised as an asset. In some cases, expenditure is incurred to generate future economic benefits. Such expenditure is often described as contributing to internally generated goodwill. ***Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.***

Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

Internally Generated Intangible Assets

It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition. It is often difficult to:

(a) identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

(b) determine the cost of the asset reliably.

The cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to-day operations.

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were ***incurred in the research phase only***.

Research Phase

No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

Examples of ***research activities*** are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Illustration 2

State how will you deal with the following matters in the accounts of U Ltd for the year ended 31.3.2013:

The company has spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product which was marketed in the accounting year 2012-13 but proved to be a failure.

Solution

As per para 41 of AS–26, no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

Therefore, in the present case, the entire expenses on publicity and research of ₹ 45 lakhs should be recognised as expense in the accounting year 2012-13.

Illustration 3

M Ltd launched a project for producing product A in November, 2008. The company incurred ₹ 30 lakhs towards Research and Development expenses upto 31st March, 2010. Due to unfavourable market conditions, the managements feels that it is not possible to manufacture and sell the product in the market for next so many years.

The management hence wants to defer the expenditure write off to future years.

Advise the company as per the applicable Accounting Standard. ***[C.A. (IPCC) — November, 2010]***

Solution

As per para 41 of AS—26: 'Intangible Assets', no intangible asset arising from research (or from research phase of an internal project) should be recognised. Expenditure on research (on the research phase of an internal project) should be recognised as an expense when it is incurred.

In this case, management feels that it is not possible to manufacture and sell the product in the market in near future. Therefore, the entire amount of ₹ 30 lakhs should be ***charged to Profit and Loss Account*** as an expense.

Illustration 4

A pharma company spent ₹ 33 lakhs during the accounting year ended 31.3.2013 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not, and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

Solution

As per para 41 of AS—26, no intangible asset arising from research (or from research phase of an internal project) should be recognised. Expenditure on research (or from research phase of an internal project) should be recognised as an expense when it is incurred.

Therefore, in the present case, the entire amount of ₹ 33 lakhs ***should be charged to the Profit and Loss Accoun***t for the year ended on 31st March, 2013.

Development Phase

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. The enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of ***development activities*** are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash generating units as set out in Accounting Standard on Impairment of Assets.

Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the enterprise's ability to secure those resources. In certain cases, an enterprise demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

Cost of an Internally-generated Intangible Asset

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time ***when the intangible asset first meets the recognition criteria*** that can be directly attributed or allocated to it on a reasonable and consistent basis.

Example : An enterprise is developing a new production process. During the year 2012, expenditure incurred was ₹ 10 lakhs, of which ₹ 9 lakhs was incurred before 1 December 2012 and 1 lakh was incurred between 1 December 2012 and 31 December 2012. The enterprise is able to demonstrate that, at 1 December 2012, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 5 lakhs.

At the end of 2012, the production process is recognised as an intangible asset at a cost of ₹ 1 lakh (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 2012). The ₹ 9 lakhs expenditure incurred before 1 December 2012 is recognised as an expense because the recognition criteria were not met until 1 December 2012. This expenditure will never form part of the cost of the production process recognised in the Balance Sheet.

Journal Entry :

(i) Intangible Assets (Production Process) A/c	**Dr.**	**₹ 1,00,000**	
Research Expenses A/c.	**Dr.**	**₹ 9,00,000**	
To Bank A/c			**₹ 10,00,000**

(Being the recognition of intangible asset to the extent of ₹ 1 lakh incurred after the date when the recognition criteria were met)

(ii) Profit and Loss A/c Dr. ₹ 9,00,000
To Research Expenses A/c ₹ 9,00,000
(Being the expenses incurred before 1 December 2012 charged to Profit and Loss Account)

During the year 2013 expenditure incurred is ₹ 20 lakhs. At the end of 2013, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 19 lakhs.

At the end of the year 2013, the cost of the production process is ₹ 21 lakhs (₹ 1 lakh expenditure recognised at the end of 2012 plus ₹ 20 lakhs expenditure recognised in 2013). The enterprise recognises an impairment loss of ₹ 2 lakhs to adjust the carrying amount of the process before impairment loss (₹ 21 lakhs) to its recoverable amount (₹ 19 lakhs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Accounting Standard on Impairment of Assets, are met.

Journal Entry :

		Dr. (₹)	Cr. (₹)
(i) Intangible Asset (Production Process) A/c	**Dr.**	**₹ 20,00,000**	
To Bank A/c			**₹ 20,00,000**
(Being the amount capitalised in respect of intangible asset)			
(ii) Amortisation (Impairment) A/c	**Dr.**	**₹ 2,00,000**	
To Accumulated Amortisation A/c			**₹ 2,00,000**
(Being the recognition of impairment)			
(iii) Profit and Loss A/c	**Dr.**	**₹ 2,00,000**	
To Amortisation (Impairment) A/c			**₹ 2,00,000**
(Being the amount charged to Profit and Loss Account)			

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use including :

(a) expenditure on materials and services used or consumed in generating the intangible asset;
(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;
(c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and
(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset.
(e) interest (subject to certain conditions)

The following are ***not components of the cost of an internally generated intangible asset*** :

(a) selling, administration and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;
(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and
(c) expenditure on training the staff to operate the asset.

Recognition of an Expense

Expenditure on an intangible item to be recognised as an expense when it is incurred unless :

(a) it forms part of an intangible asset that meet the recognition criteria; or
(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. This expenditure should be included in Goodwill.

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred.

Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS—10.
Start-up costs may consist of
   (i) preliminary expenses, e.g., legal and secretarial costs;
   (ii) expenditure to open a new facility or business
   (iii) expenditures for commencing new operations
   (iv) launching new products or processes;

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

Past Expenses not Recorded as an Asset

Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a latter date.

Illustration 5

Himalaya Ltd. in the past three years spent ₹ 75,00,000 to develop a drug to treat cancer, which was charged to Profit and Loss Account since they did not meet AS—26 criteria for capitalisation. In the current year, approval of the concerned Government Authority has been received. The company wishes to capitalise ₹ 75,00,000 and disclose it as a prior period item. Is it correct ? Give reasons for your view.

[C.A. (Final) — November, 2010]

Solution

Himalaya Ltd. cannot capitalise ₹ 75,00,000 because it has already been charged to Profit and Loss Account in the previous accounting years. Para 58 of AS—26 prohibits reinstatement of expenditure recognised as an expenses in previous annual financial statements or interim reports.

Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance.

The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only ***rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset***.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally purchased or internally generated) is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation

Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life.

Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount.

Example: Your company X Ltd. is the owner of a patent. At present, carrying amount of the patent is ₹ 4,00,000. The fair value is ₹ 6,00,000. The patent will continue to be amortised.

Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period ***longer*** than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise amortises the intangible asset over the best estimate of its useful life.

Example : Your company, J.P. Hydro Ltd. has purchased exclusive right to generate and sale hydro-electric power for 40 years at a cost of ₹ 40 crores. The cost of production of this power is much lower than those from thermal power. It is the assessment of the management that the demand for power will increase in the years to come and will remain strong for at least 40 years. The company amortise the right to generate and sale power over 40 years.

Journal Entry :

Amortisation of Right A/c	**Dr.**	**100,00,000**	
To Accumulated Amortisation A/c			**100,00,000**
(Being the annual amortisation of right to generate and sale hydro-electric power)			
Profit and Loss A/c	**Dr.**	**100,00,000**	
To Amortisation of Right A/c			**100,00,000**
(Being the amount charged to Profit and Loss Account)			

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and
(b) renewal is virtually certain.

There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

The following factors, among others, indicate that renewal of a legal right is virtually certain:

(a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;
(b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and
(c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

Amortisation Method

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (See AS—2, 'Valuation of Inventories').

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

Extract from the Annual Report of Reliance Industries Ltd. : 2013-14

Intangible Assets

Intangible Assets are stated at cost of acquisition net of recoverable taxes less accumulated amortisation / depletion and impairment loss, if any. The cost comprises purchase price, borrowing costs and any cost directly attributable to bringing the asset to its working condition for the intended use and net charges on foreign exchange contracts and adjustments arising from exchange rate variations attributable to the intangible assets.

Illustration 5

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalised the cost and started amortising at ₹ 10,00,000 per annum. After two years it was found that the product life cycle may continue for another 5 years from then. The net cash flow from the product during these 5 years were expected to be ₹ 36,00,000; ₹ 46,00,000; ₹ 44,00,000; ₹ 40,00,000 and ₹ 34,00,000. Find out the amortisation cost of the patent for each of the year.

[C.A. (Final) — May, 2006]

Solution

The answer of the above question has been given on the assumptions that :

(i) the patent is renewable; and
(ii) the company got it renewed after expiry of 5 years.

Swift Ltd. amortised ₹ 10,00,000 p.a. for the first two years. ₹ 20,00,000 (It is assumed that the company has amortised the patent for two years on the basis of economic benefits derived from the product manufactured under the patent), has been amortised and the balance ₹ 60,00,000 can be amortised during the next 5 years on the basis of net cash flows arising from the sale of the product. The amount to be amortised each year :

	₹
3rd year = $\frac{60,00,000}{200,00,000} \times 36,00,000$	= 10,80,000
4th year = $\frac{60,00,000}{200,00,000} \times 46,00,000$	= 13,80,000
5th year = $\frac{60,00,000}{200,00,000} \times 44,00,000$	= 13,20,000
6th year = $\frac{60,00,000}{200,00,000} \times 40,00,000$	= 12,00,000
7th year = $\frac{60,00,000}{200,00,000} \times 34,00,000$	= 10,20,000
Total	60,00,000

Residual Value

The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

 (i) residual value can be determined by reference to that market; and

 (ii) it is probable that such a market will exist at the end of the asset's useful life.

Example:
It is the policy of TMH Ltd. to keep copyright for 8 years. The company has just purchased a new copyright for ₹ 2,00,000. Similar copyright which is 8 years old, is available at today's market price at ₹ 40,000. This can be the estimated residual value of the new copyright.
Annual amortisation will be :

$$\frac{2,00,000 - 40,000}{8} = ₹\ \mathbf{20,000}$$

Review of Amortisation Period and Amortisation Method

The amortisation period and the amortisation method should be reviewed ***at least at each financial year end***. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS–5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Example : It is the policy of TMH Ltd. to amortise copyright in 8 years. According to their management's assessment, the residual value will be 20% of the original cost of the copyright.
Industry practice is to amortise copyright in 10 years with residual value 10% of the original cost.
After consulting experts, TMH has decided to follow industry practice.
These changes should be accounted for under AS—5.

During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure that improves the condition of the asset beyond its originally assessed standard of performance. Also, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Recoverability of the Carrying Amount — Impairment Losses

To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets (AS—28). That Standard explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and
(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Illustration 6

What will be the treatment of the following in the final statement of accounts for the year ended 31.3.2013 of a limited company:

In 2011-12 the company has spent and carried forward in the books, a total of ₹ 5,00,000 on developing a cure for cancer. During the current year, i.e., 2012-13, it is decided to terminate this product, as test results in the current year have proved adverse.

[C.A. — Adapted]

Solution

An intangible asset should be derecognised on disposal or when no future economic benefits are expected from the use and subsequent disposal.

Gains or losses arising from the retirement should be recognised as income or expense in the Profit and Loss Account.

Here, in this case, the company has decided to terminate the product, because of adverse test results. Therefore, the entire unamortised amount of ₹ 5,00,000 should be expensed off in the current year.

Disclosure

General

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

(a) the useful lives or the amortisation rates used;
(b) the amortisation methods used;
(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;
(d) a reconciliation of the carrying amount at the beginning and end of the period showing:
  (i) additions, indicating separately those from internal development and through amalgamation;
  (ii) retirements and disposals;
  (iii) impairment losses recognised in the statement of profit and loss during the period (if any);
  (iv) impairment losses reversed in the statement of profit and loss during the period (if any);
  (v) amortisation recognised during the period; and
  (vi) other changes in the carrying amount during the period.

A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

(a) brand names;
(b) mastheads and publishing titles;
(c) computer software;
(d) licences and franchises;
(e) copyrights, and patents and other industrial property rights, service and operating rights;
(f) recipes, formulae, models, designs and prototypes; and
(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

An enterprise discloses information on impaired intangible assets under Accounting Standard on Impairment of Assets.

An enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS—5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;
(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;
(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and
(d) the amount of commitments for the acquisition of intangible assets.

Research and Development Expenditure

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

Research and development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities.

Other Information

An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

Transitional Provisions

Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than 10 years and the period of 10 years has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period of 10 years has not expired on the date of this Statement coming into effect and:

(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

(b) if the remaining period as per the accounting policy followed by the enterprise:

  (i) is shorter as compared to the balance of the period of 10 years, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

  (ii) is longer as compared to the balance of the period dof ten years, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period of 10 years.

Illustration 7

An intangible asset appears in Balance Sheet of A Co. Ltd. at ₹ 16 lakhs as on 31st March, 2014. The asset was acquired for ₹ 40 lakhs in April, 2001. The company has been amortising the asset value on straight line basis. The policy is to amortise for 20 years.

Do you advice the company to amortise the entire asset value in the books of the company as on 31st March, 2014 ?

[C.A. (PE-II) — November, 2005]

Solution

AS—26 'Intangible Assets' came into effect for the accounting periods on or after 1.4.2013.

As per para 99, where on the date of this statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than 10 years and the period of 10 years has expired on the date of this statement coming into effect, the carrying amount appearing in the Balance Sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserve.

Since the amortisation period of 10 years has already been expired on 31st March, 2014, the carrying amount of ₹ 16 lakhs has to be eliminated with a corresponding adjustment to the balance of revenue reserve on 31st March, 2014.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. The cost of an intangible asset comprises :

   (i) purchase price
   (ii) import duties
   (iii) general office overheads

   Which of the following alternative is correct ?

   A (i) and (iii) above
   B (i) and (ii) above
   C (ii) and (iii) above

2. If an intangible asset is acquired in exchange for share of the reporting enterprise, the asset is recorded :
   A at the fair value of the intangible asset
   B at the fair value of the shares issued
   C at the fair value of the intangible asset or at the fair value of the shares issued, which is more clearly evident
3. Start-up cost, training costs and costs of relocating should be accounted for as :
   A deferred revenue expenditures
   B expenses
   C intangible assets
4. Internally generated goodwill :
   A should be recognised as a fixed asset
   B should be recognised as an intangible asset
   C should not be recognised as an asset
5. An intangible asset acquired in exchange of another asset, should be recorded
   A at nil value
   B at the net book value of the asset given up
   C at the original cost of the asset given up
6. Expenditure on research should be recognised as
   A a deferred revenue expenditure
   B a capital expenditure
   C a revenue expenditure
7. At present, carrying amount of a patent is ₹ 4,00,000. The fair value is ₹ 6,00,000. The patent will
   A not be amortised any more
   B continue to be amortised
   C be revalued at ₹ 6,00,000
8. The amortisation period and amortisation method should be reviewed
   A at least twice in a financial year
   B at least at each quarter end
   C at least at each financial year end
9. Amortisation changes for a period are recorded :
   A as an exceptional item
   B only in the profit and loss account
   C in the profit and loss account, or as part of the cost of another asset (such as inventories)
10. Which of the following is not a component of the cost of an internally generated intangible asset:
    A the salaries and wages of the security staff
    B any expenditure that is directly attributable to generate the asset
    C overheads that are necessary to generate the asset

PRACTICAL QUESTIONS

I. AB Ltd. launched a project for producing product X in October 2004. The company incurred Rs 20 lakhs towards Research and Development expenses upto 31st March, 2006. Due to prevailing market conditions, the management came to conclusion that the product cannot be manufactured and sold in the market for next 10 years. The management hence want to defer the expenditure write off to future years.
Advice the company as per the applicable Accounting Standard. ***[C.A. (PE-II) — May, 2006]***

Guide to Answers

Multiple Choice

1. B; **2.** C; **3.** B; **4.** C; **5.** B; **6.** C; **7.** B; **8.** C; **9.** C; **10.** A

Practical Questions

1. The entire amount of ₹ 20 lakhs should be charged to Profit and Loss Account of the current year.

AS — 29 : Provisions, Contingent Liabilities and Contingent Assets
[Effective Date : 1st April, 2009]

Introduction

A provision is a charge against profit for the purpose of providing for any liability or loss. The anticipated liability or loss is likely or certain to be incurred, but the amount or the date on which they will arise may not be ascertained with reasonable accuracy.

A provision can be created for the following purposes:

1. ***For liabilities and charges*** (e.g., Provision for income tax)
2. ***For valuation adjustment for fixed assets*** (e.g., Provision for depreciation)
3. ***For valuation adjustment for current assets*** (e.g., Provision for bad and doubtful debts)

Provisions are sometimes misused for 'profit manipulation' by inflating provisions to reduce profit in good years, then reversing those in the bad years.

The main intention of AS—29 is to limit provisions to the specific underlying liabilities.

Here, it should be noted that AS—29 is applicable only to '***provision for liability and charges***' as mentioned above (1). The provisions for adjustments to the carrying amounts of assets are outside the scope of AS—29.

Certain items (e.g., warrantees, guarantees) do not appear in the Balance Sheet. To give complete picture of the enterprise's financial positions, these items must be noted in the financial statements as '***contingent liabilities***'.

There may be some possible assets which are not recorded in the financial statements because of its uncertainity. AS—29 defines them and prescribes their reporting treatment.

Objective

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

The objective of this Statement is also to lay down appropriate accounting for contingent assets.

Scope

This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, ***except***:

(a) those resulting from financial instruments that are carried at fair value;
(b) those resulting from executory contracts;
(c) those arising in insurance enterprises from contracts with policy-holders; and
(d) those covered by another Accounting Standard.

Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:

(a) construction contracts (see AS—7, Construction Contracts);
(b) taxes on income (see AS—22, Accounting for Taxes on Income);
(c) leases (see AS—19, Leases); and
(d) retirement benefits (see AS—15, Accounting for Retirement Benefits in the Financial Statements of Employers).

Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Statement does not address the recognition of revenue. AS—9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Statement does not change the requirements of AS—9.

This Statement applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS—24, Discontinuing Operations.

Definitions

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

A ***provision*** is a liability which can be measured only by using a substantial degree of estimation.

A ***liability*** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An ***obligating event*** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A ***contingent liability*** is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

Example: Your company X Ltd. has given a guarantee for a loan of ₹ 20,00,000 taken by its subsidiary S. Ltd. from ICICI Bank Ltd.

Whilst the management of X Ltd. hopes that there will be no claim against the company. However, there is a risk that S. Ltd. will not pay the loan and a claim will be made on the company.

X Ltd.'s liability will arise if

(i) S Ltd. fails to pay the loan; or

(ii) the security given by S Ltd. is not sufficient to cover the loan etc.

This will create a contingent liability based on the assessment of the risk.

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.

Example: Your company, HM Ltd. is manufacturing and selling motor cars. One of the customers sued the company for ₹ 4,00,000 for damages. The car met with an accident because of break failure. It is the claim of the customer that there were manufacturing defects in the breaking system. HM Ltd. disputes the claim. It is not clear whether or not the company will be liable. If it is found liable, the amount of claim is uncertain.

The uncertainties make the claim a contingent liability.

A ***contingent asset*** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation — an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation — an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A ***restructuring*** is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

Provisions and Other Liabilities

Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Although it is sometimes necessary to estimate the amount of accruals, the degree of estimation is generally much less than that for provisions.

Recognition of Provisions

A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

Present Obligation

Generally, it will be clear whether a past event has given rise to a present obligation.

In a law suit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including the opinion of experts.

The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that ***a present obligation exists*** at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that ***no present obligation exists*** at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Past Event

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, ***no provision is recognised for costs that need to be incurred to operate in the future***. The only liabilities recognised in an enterprise's balance sheet are ***those that exist at the balance sheet date***.

Example: Your company K Chemicals Ltd. has been sued by Pollution Control Board for ₹ 5,00,000 for environmental damage. The management believes that the company will have to pay the entire amount. For future protection, the company will have to buy new machines for ₹ 10,00,000.
Here, only ₹ 5,00,000 should be included in the provision of the company. ₹ 10,00,000 will not be included as it is to be incurred to operate in future.

It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise.

Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused.

Because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future. Because the enterprise can avoid the future expenditure by its future actions, it has no present obligation for that future expenditure and no provision is recognised.

Example: Your company Modern Travels Ltd. is operating a fleet of 20 buses (all diesel) in National Capital Region (NCR). It has been notified by the Government that from 1st January, 2014 no diesel buses will be allowed to ply in the NCR. Only CNG/LPG buses will be allowed to ply. In the financial statements of 2013, no provision is required because it has no present obligation for future expenditure. The company can avoid the future expenditure by its future actions, e.g., company may withdraw all buses in NCR and can use it in long distance routes.

It is not necessary, however, to know the identity of the party to whom the obligation is owed - indeed the obligation may be to the public at large.

Example: Your company Canon Ltd. is manufacturing and selling digital cameras. All cameras sold is covered by 1 year warranty. Your company do not know who will make a claim but it is known to the company that a number of claims will be made. The company must make a provision accordingly.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law.

Example: In 2012, when your company MM Ltd. caused environmental damage at the time of mining, there was no obligation to remedy the consequences. In January 2013, before the finalisation of the accounts, a new law required the existing damage to be rectified. The causing of the environmental damage has become an obligating event. A provision will be made in the accounts for 2012.

Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation ***is virtually certain to be enacted***. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

Where it is not probable that a present obligation exists, an enterprise discloses a ***contingent liability***, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items.

Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.

Recognition of Contingent Liability

An enterprise should not recognise a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

Joint and Several Liability

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

Example: In a chemical park, there are ten manufacturing units of equal size. All the units are jointly and severally liable for any environmental damages. Your company K Chemicals Ltd. is the owner of one of the manufacturing unit.

A case has been brought against the management committee of the 'Chemical Park' of ₹ 50,00,000 for environmental damages.

Your company should make a provision of ₹ 5,00,000 (1/10th of the total claim) and a contingent liability of ₹ 45,00,000. The contingent liability recognises that other units may not pay and you will be liable to pay the total claim.

Relationship Between Provisions and Contingent Liabilities

All provisions are contingent because the amount or the date on which they will arise may not be ascertained with reasonable accuracy.

In this statement, the term 'contingent' has been used for liabilities as well as assets. These contingent items are not recorded in the ***Balance Sheet***.

It should be noted that provisions are recorded as liability in the Balance Sheet. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Example: Your company R Ltd. is the manufacturer of a cancer drug. One of the customers has sued the company for ₹ 4,00,000 for the product's side effect. In 2012, R Ltd. disclosed it as a contingent liability, as the management believed that it was unlikely that they would be paying any damages.

At the time of half-yearly review in 2013, the company consulted experts and made sure that the compensation of ₹ 4,00,000 will be payable to the customer.

This ₹ 4,00,000 of contingent liability will be changed to ₹ 4,00,000 provision.

Recognition of Contingent Assets

An enterprise should not recognise a contingent asset in the financial statements. It is usually disclosed in the ***report of the approving authority*** (e.g., Directors' Report in case of a company).

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised.

Example: In 2012 your company R Ltd. has made a claim of ₹ 10,00,000 compensation against its rival C Ltd for patent violation. The claim has gone to court.

R Ltd. should treat it as a contingent asset.

Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

Example: In July 2013, R Ltd.'s claim for ₹ 10,00,000 against C Ltd. has been successful and court has directed C Ltd. to pay ₹ 10,00,000 within 30 days from the date of the order. There is no risk of non-payment.
R Ltd. should treat it as an income in 2013.
Journal entry :

C Ltd. A/c	**Dr. 10,00,000**	
To Other Income A/c		**10,00,000**
(Being the recognition of contingent asset as income)		

Measurement

Best Estimate

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value. The provision is measured before tax.

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

Example 1 : At the time of selling a mobile phone, your company India Mobile Co. Ltd. is giving one year's warranty to the customers. During the last 5 years the company is incurring expenses between ₹ 4,00,000 and ₹ 6,00,000.
According to management the most likely figure for the current year will be ₹ 5,00,000. This should be recorded as provision.
Example 2 : L&T Ltd. has to rectify a serious fault in a 'blast furnace', built for a client TISCO Ltd. If the repairing is done in first attempt, the probable cost will be ₹ 2,00,000. If it is probable that second visit will be needed, the cost of the 2nd visit will be ₹ 50,000. Engineers are not confident to repair the fault at first attempt. In this case, the company should make a provision for a large amount, i.e., ₹ 2,00,000 + ₹ 50,000 = ₹ 2,50,000.

Risks and Uncertainties

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated.

However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

Future Events

Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

It is appropriate to include expected cost reductions associated with increased experience.

An enterprise does not anticipate the development of a completely new technology unless it is supported by sufficient objective evidence.

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

Expected Disposal of Assets

Gains from the expected disposal of assets should not be taken into account in measuring a provision.

An enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

Example 1 : Your company TM Ltd. is manufacturing and selling cars. During the year 2012, the company sold 20,000 cars of a certain model. During the warranty period, the company received certain complaints from customers in respect of "Shock Absorber" of the car. The company has decided to recall all cars and replace the "Shock Absorbers". The total expenses will be ₹ 200,00,000.

As per agreement with manufacturer of "Shock Absorbers" all defective items has to be replaced free of cost.

By the end of 2012, no reimbursement has been agreed upon.

In 2012, a provision should be made for ₹ 200,00,000.

Example 2 : Let us assume that in 2013, the manufacturer of "Shock Absorbers" agreed to pay ₹ 160,00,000 as reimbursement of expenses for replacement of shock absorbsers.

The reimbursement should be recognised as a separate asset in 2013.

In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Example : In 2012, your company X Ltd. provided ₹ 10,00,000 for patent dispute case.

In 2013, the dispute has been settled out of court for ₹ 6,00,000.

In 2013, provision of ₹ 4,00,000 is to be reversed.

Use of Provisions

A provision should be used only for expenditures for which the provision was originally recognised.

Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Example : Your company MHK Ltd. has a provision of ₹ 4,00,000 for a law suit. The provision is no longer required. However, the company needs a provision of ₹ 5,00,000 for environmental damage. This provision should be a separate provision. Surplus law suit provision should not be adjusted against this.

Application of the Recognition and Measurement Rules

Future Operating Losses

Provisions should not be recognised for future operating losses. Future operating losses do not meet the definition of a liability and the general recognition criteria set out for provisions.

Restructuring

Restructuring is a programme that is planned and controlled by management and materially changes either :

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

Example 1 : Your company, Dalmia Resorts Ltd. is operating a chain of hotels in hills. The company is also running a business of fast food through its own outlets.

The company decides to sell its fast food business for ₹ 2 crores. This will be treated as restructuring because this reduces the scope of business of the company.

Example 2 : Taking the above example, let us assume that Dalmia Resorts Ltd. decides to sell the entire business to Hilton Hotel Ltd. but continue to manage the business through management contracts with the new owner.

It will be treated as restructuring because this changes the manner in which business is conducted.

The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions are met.

A restructuring provision ***should*** include only the direct expenditures arising from the restructuring which are those that are both :

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

A restructuring provision ***does not*** include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Example : Your company Essar Oil Ltd. is losing money on petroleum retail business. The company has restructured the business at cost of ₹ 2 crores. The company also spends ₹ 20,00,000 on retraining and ₹ 30,00,000 on new equipment. The restructuring provision will be limited to ₹ 2 crores. The cost of retraining and new equipment will not be taken into consideration.

Illustration 1

An airline is required by law to overhaul its aircraft once in every five years. The Pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard 29.

[C.A. (IPCC) — May, 2012]

Solution

As per para 14 of AS—29, a provision should be recognised when :

(a) an enterprise has a present obligation as a result of a past event;

(b) it is possible that an outflow of resources emboding economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If the above conditions are ***not*** met, no provision should be recognised.

In this present case, Pacific Airlines has no present obligation, therefore no provision should be recognised.

Overhauling of aircraft once in every 5 years as required by law is a future obligation. Therefore, it is not to be recognised as a provision. In coming years, the company can avoid the future overhauling expenses by selling the aircraft. However, an obligation might arise to pay fines or penalties if the overhauling is not done after completion of five years. It is not possible to estimate the amount of obligation at this stage, so no provision should be made for penalties or fines.

Illustration 2

At the end of the financial year ending on 31st December, 2013, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors.

The possible outcome as estimated by the Board is as follows :

Particulars	Probability (%)	Loss (₹)
In respect of five cases		
Win	100	—
Next ten cases		
Win	60	—
Lose (low damages)	30	1,20,000
Lose (high damages)	10	2,00,000
Remaining five cases		
Win	50	—
Lose (low damages)	30	1,00,000
Lose (high damages)	20	2,10,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Solution

As per para 14 of AS—29, a provision should be recognised when :

(a) an enterprise has a present obligation as a result of a past event;

(b) it is possible that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised. For the next 10 cases and remaining 5 cases, no provision should be created, since they cannot meet the above criteria. Therefore, a contingent liability is to be created in respect of these cases, which is computed as under :

Cases	Anticipated Loss per Case	Anticipated Total Loss
Five cases	Nil	Nil
Next ten cases	₹ 1,20,000 x 30% + ₹ 2,00,000 x 10% = ₹ 56,000	₹ 5,60,000 (₹ 56,000 x 10)
Remaining ten cases	₹ 1,00,000 x 30% + ₹ 2,10,000 x 20% = ₹ 72,000	₹ 3,60,000 (₹ 72,000 x 5)

Thus, an amount of ₹ 9,20,000 (₹ 5,60,000 + ₹ 3,60,000) should be disclosed as a ***contingent liability***.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below :

1. Profit manipulation often involves :

   A contingent liability

   B contingent assets

   C provision

2. AS—29 is applicable only to :
   A provision for valuation adjustment for fixed asset
   B provision for liabilities and charges
   C provision for valuation adjustment for current assets
3. A provision should be recognised
   A for a future obligation
   B for a present obligation
   C for a future event
4. An obligating event is
   A a past event that leads to a present obligation
   B an event that creates a legal obligation
   C a liability of uncertain timing, or amount
5. Gains from the expected disposal of assets should
   A be taken into consideration in measuring a provision
   B not be taken into account in measuring a provision
   C be taken into account in measuring a provision if certain conditions are satisfied
6. Provisions are reported
   A as a part of accruals
   B as a part of trade payable
   C separately
7. A restructuring provision should include
   A refraining cost
   B marking cost
   C none of the above
8. The amount recognised for the reimbursement
   A may be more than the amount of the provision
   B should not exceed the amount of the provision
   C none of the above
9. Warranty claims normally generate a
   A contingent liability
   B provision
   C none of the above
10. Contingent assets are
   A shown in the balance sheet
   B shown below the balance sheet just like contingent liabilities
   C disclosed in the directors' report of the company

Guide to Answers

1. C; **2.** B; **3.** B; **4.** A; **5.** B; **6.** C; **7.** C; **8.** B; **9.** B; **10.** C

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Ratio Analysis

Meaning of Ratio

A ratio is the relationship between one value and another. It is an expression of a mathematical relationship between one quantity and another. The ratio of 200 : 100 is 2 : 1 or 2. The calculation of ratios is an important technique for analysing and understanding profit and loss accounts and balance sheets. The elements that constitute the ratio express a meaningful relationship. For example, there is a relationship between sales and sundry debtors, between net profit and capital investment, and between current assets and current liabilities.

Meaning of Ratio Analysis

Ratio analysis is the most widely used technique for interpreting and comparing financial reports. It analyses financial data from the firm's Profit and Loss Account and the Balance Sheet. The figures appearing in the Profit and Loss Account and the Balance Sheet convey a considerable amount of information in terms of their absolute amounts. But the relationship between one figure and another can be more useful. Accounting ratios show relationship among items in financial statements. These are used in the assessment of profitability, liquidity, activity and the capital structure of the enterprise.

Objectives of Ratio Analysis

1. To allow comparisons to be made which assist in predicting the future.
2. To investigate the reasons for the changes.
3. To construct a simple explanation of a complicated financial statement by its expression in one figure.
4. To permit the charting of a firm's history and the evaluation of its present position.
5. To provide indicators of a firm's past performance in terms of its operational activity and profitability; and near-present financial condition.
6. To see what information users can get from the accounting system output.

Advantages of Ratio Analysis

1. It is used as an aid to simplify the comprehension of financial statements of an organisation.
2. It is used as an aid to analysis and interpretation of financial statements and acts on an index of the efficiency or otherwise of the enterprise.

3. It provides data for inter-firm comparison in regard to operating performance and financial results, which helps the management in planning the future course of action.
4. It can be used for comparing the working results of the different divisions of the same organisation.
5. Accounting ratios based on past performance is helpful in predicting the future performance of the different divisions and the business as a whole. It can be used for making investment decisions.
6. It can help the management in planning and forecasting and provides clues on future problems.
7. Without going into much details, the position of the business can be ascertained at a glance.
8. Accounting reports can be strengthened by the use of accounting ratio.

Limitations of Ratio Analysis

1. Financial statements suffer from a number of limitations. When the ratios are constructed from those financial statements, ratios suffer from the inherent weaknesses of the accounting system itself.
2. By using ratios, forecasts of future of a business may not prove correct. This is because, ratios are all based on past happenings and not future probabilities. They are subject to change in the future.
3. Accounting ratios are simply clues. They do not indicate the causes of difference. Therefore, they are not considered as basis for immediate conclusion.
4. Ratios are not free from individual bias, because accounting is man-made. Two identical business units with the same level of operation and investment may show highly incomparable financial results.
5. There is lack of proper standards for ideal ratios. There are many rules of thumb, since it is not possible to establish well accepted absolute standards.
6. While constructing accounting ratios, arithmetic window dressing is possible by concealing vital facts and presenting the financial statements in such a fashion as to show the business in a better position than it actually is.

Standards of Comparison

There are broadly three bases of comparison for ratios calculated from financial statements.

1. Past periods : A comparison can be made between the most recent year and previous years. At the time of comparison, it is important to see the economic environment and political environment of the concerned periods.

2. Planned performance : Some companies formulate their financial plans in term of different ratios. These ratios are compared with the actual ratios.

3. Industry ratio : This is very useful basis of comparison, particularly, if different companies can be identified as being valid for comparison.

Users of Ratios

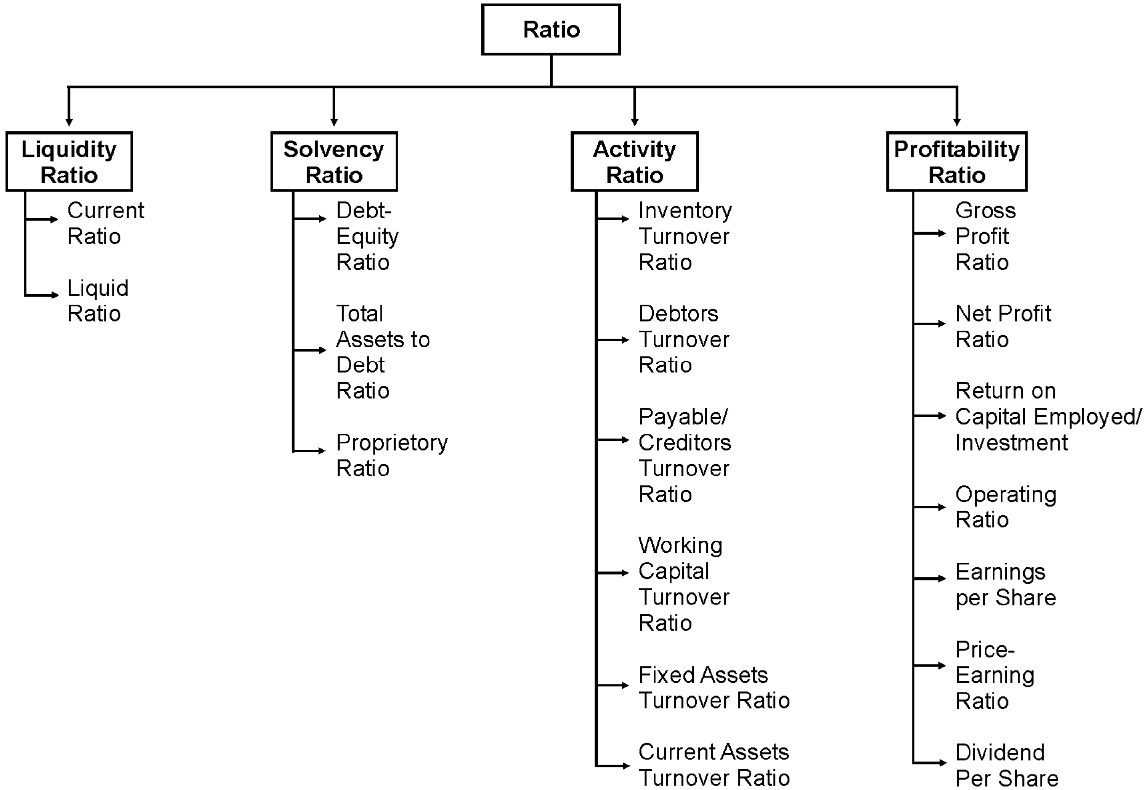
Users of ratios can be classified into two groups — internal and external. Internal group consist of directors, shareholders, partners, managers, etc. External group consist of investors, lenders, suppliers, employees, labour union, customers, etc.

Different class of ratios will serve the purpose of different users group. For example, suppliers are interested only in liquidity ratios. The shareholders and managers are interested in all classes of ratios.

Classification of Ratio*

Ratios are classified according to the need of different interested groups (e.g., shareholders, lenders, investors, management, etc.). [***See Diagram next page***]

*This is the most common classification of ratio. According to the need of the organisation / investors, ratio can be classified differently.



Liquidity Ratios

Liquidity ratios measure the ability of a firm to meet its short-term obligations. Short-term is conventionally viewed as a period up to one year. By liquidity, we mean the amount of cash or cash equivalents the firm has on hand and the amount of cash it can arrange in a short period of time. Cash is the most liquid asset. It includes currency, demand deposits with bank. Cash equivalents are short-term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. Inventories and debtors are somewhat less liquid.

Liquidity is essential for smoothly conducting of business activities. If the firm has a poor liquidity position, it may not be able to make timely payments to the creditors and, in effect, will not be in a position to buy goods or services in future on credit. Poor or insufficient liquidity may result in a serious fundamental problem, particularly in times of adversity, such as when a business unit is shut down by strike or a steep rise in the price of a raw material.

High liquidity provides flexibility to take advantage of changing market conditions. For example, an 'Ata' or 'Suji' manufacturing company can buy wheat at very cheap rate at harvesting time if its liquidity position is good.

There are number of reasons, apart from the above, why enterprises need liquidity. They are as under :

(a) To invest in projects that were agreed in previous year(s).
(b) To take advantages of an investment opportunity that arises.
(c) To cope up with boom and slump conditions which affect a business in terms of sales, interest rates, etc.
(d) To keep extra funds where sales are varying, e.g., in a seasonal business.
(e) To meet working capital needs.

The above scenarios highlight why measures of liquidity are of great importance.

The ratios which indicate the liquidity of an enterprise are :

1. Current Ratio
2. Acid Test Ratio / Quick Ratio / Liquid Ratio

Current Ratio

Current Ratio is the relationship between current assets and current liabilities. It is quoted as a single figure (not a percentage). Current assets are cash, cash equivalents and other assets which are expected to be realised in cash or sold or consumed within one year (or the normal operating cycle of the company if it is greater than one year). On the other hand, current liabilities are the obligations of the business which are repayable within a relatively short period of time, usually one year. Current liabilities are of two types. The first type arises from operating activities and includes outstanding expenses, tax payable etc. The second type of current liabilities arises from financing activities and includes short-term borrowings and any current portion of long-term debts.

Examples of Current Assets are : (i) cash in hand; (ii) cash at bank; (iii) cash equivalents; (iv) short-term investments; (v) trade debtors; (vi) bills receivables; (vii) accrued income; (viii) prepaid expenses; (ix) inventories; (x) advance tax.

Some Important Items

1. Prepaid Expenses : Prepaid expenses are expenditure for future benefits and it includes insurance premium, rent, taxes, etc. Prepaid expenses are classified as current assets even though they will never be converted into cash as the typical current assets would be. Classification of prepaid expenses as current asset is justified on the ground that if the expenditure for the present time had not occurred, cash would have to be expended in the future.

2. Deferred Tax Assets and Deferred Tax Liabilities : Current deferred tax assets do not represent expected cash inflows in the form of tax refunds. Similarly, current deferred tax liabilities do not represent future cash outflows. These are temporary differences of recurring nature. At the time of calculating current ratio these are to be ignored.

Examples of Current Liabilities are : (i) trade creditors; (ii) bills payable; (iii) liability for taxes; (iv) outstanding expenses; (v) income received in advance; (vi) provision for taxation; (vii) proposed dividend; (viii) short-term bank loan (e.g., cash credit); and (ix) current portion of long-term loan.

Formula to Learn

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

At the time of preparation of Balance Sheet as per Schedule III to the Companies Act, 2013 'Bank Overdrafts' are included as a component of Cash and Cash Equivalents. Therefore, in majority cases, 'Bank Overdraft' figures will not be available separately. However, in the examination problems, it may appear on the liability side of the Balance Sheet. At the time of calculating Current Assets, the overdraft is to be deducted from the Cash and Bank Balances.

Significance of Current Ratio

Current Ratio is widely used as a measure of liquidity because of its ability to measure:

1. Current Liability Coverage : The higher the ratio of current assets with respect to current liabilities, the greater the assurance that current liabilities will be paid in the time.

2. Buffer against Losses : The current ratio shows the margin of safety available to cover the loss on sale or realisation of non-cash current assets.

3. Reserve of Liquid Funds : The current ratio shows the margin of safety available at the time of uncertainties and random shocks to companies cash flow.

4. Inefficient use of Resources : A current ratio much higher than 2 : 1 can signal inefficient use of resources and a reduced rate of return.

Limitations of Current Ratio

Although no hard and fast rule can be laid down, a current ratio of 2 : 1 is generally considered good. It should be noted that downward changes in the current ratio may indicate liquidity problems. The current ratio is a static measure of liquidity at a point of time. It can not indicate the future cash inflows. The future cash inflows are the strong indicator of liquidity. Another limitation of current ratio is the existence of inventories in current assets. Inventories is a permanent component of current assets. No company will sell its entire inventories for discharging its current obligations because inventories-out may lead to other problems such as good customers may change their loyalty.

Acid Test Ratio / Quick Ratio / Liquid Ratio

The quick ratio is the relationship between quick assets and current liabilities. Quick assets are current assets less inventories, i.e., cash, bank, cash equivalents, debtors and readily realisable marketable securities. A more stringent test of short-run solvency is the quick ratio. It is widely regarded as the most useful single test of liquidity. It differs from current ratio in the exclusion of Inventories, because they are normally sold on credit (converted into a debtor) and then the debtors must be collected before cash is realised. Thus, inventories is two steps away from cash rather than just one. Another reason for the omission of inventories is quick assets from that it may be valued in different ways by different firms. Yet we must remember that inventories for some companies are more liquid than slow paying debtors, e.g., oil company's inventories are much more liquid than its debtors. These debtors are Railways, PSU, State Electricity Boards and the like. Prepaid expenses are also omitted because they are used up in operations rather than converted into cash and, in effect, are not capable of covering current liabilities.

When viewed with the current ratio, the quick ratio gives an idea of the influence of inventories and prepaid expenses. As a rule of thumb, a quick ratio of 1 : 1 is considered satisfactory.

Formula to Learn

$$\text{Acid Test Ratio} = \frac{\text{Quick Assets (Cash + Bank + Cash Equivalents + Debtors + Bills Receivable)}}{\text{Current Liabilities}}$$

Significance and ***Limitations*** of Acid Test Ratio are similar to that of Current Ratio.

Illustration 1

From the following Balance Sheet of Raman & Co., you are required to calculate : (i) Current Ratio; and (ii) Quick Ratio.

Liabilities	₹	Assets	₹
Capital	3,00,000	Land and Building	2,00,000
Reserves	1,55,000	Plant and Machinery	1,00,000
Sundry Creditors	50,000	Inventories	1,20,000
Bills Payable	30,000	Sundry Debtors	1,00,000
Short-term Loan	40,000	Cash and Bank	85,000
Provision for taxation	30,000		
	6,05,000		6,05,000

Solution

(i) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{3{,}05{,}000 \text{ (Note 1)}}{1{,}50{,}000 \text{ (Note 2)}} = 2.03 : 1$

(ii) Quick Ratio $= \dfrac{\text{Quick Assets}}{\text{Current Liabilities}}$

$= \dfrac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = \dfrac{3{,}05{,}000 - 1{,}20{,}000}{1{,}50{,}000} = \dfrac{1{,}85{,}000}{1{,}50{,}000} = 1.23 : 1$

Working Notes :

(1) Current Assets	₹	(2) Current Liabilities	₹
Inventories	1,20,000	Sundry Creditors	50,000
Sundry Debtors	1,00,000	Bills Payable	30,000
Cash and Bank	85,000	Short-term Loans	40,000
		Provision for Taxation	30,000
	3,05,000		1,50,000

Illustration 2

Compute the Current Ratio and Quick Ratio from the following figures extracted from X & Co Ltd.:

Goodwill ₹ 80,000; Land and Building ₹ 60,000; Inventories ₹ 13,640; Sundry Debtors ₹ 26,150; Cash ₹ 2,430; Payments in Advance ₹ 3,100; Bills Receivable ₹ 1,130; Advance Income Tax paid ₹ 5,000; Sundry Creditors ₹ 20,287; Bills Payable ₹ 900; Short-term Loan ₹ 2,600; Provision for Taxation ₹ 6,200; Proposed Dividend ₹ 4,313;

Solution

Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{51{,}450 \text{ (Note 1)}}{34{,}300 \text{ (Note 2)}} = 1.5 : 1$

Quick Ratio $= \dfrac{\text{Quick Assets}}{\text{Current Liabilities}}$

$= \dfrac{\text{Current Assets} - \text{Stock} - \text{Payments in Advance} - \text{Advance Income Tax (Note 4)}}{\text{Current Liabilities}}$

$= \dfrac{51{,}450 - 13{,}640 - 3{,}100 - 5{,}000}{34{,}300} = \dfrac{29{,}710}{34{,}300} = 0.87 : 1$

Working Notes :

(1) Current Assets	₹	(2) Current Liabilities	₹
Inventories	13,640	Sundry Creditors	20,287
Sundry Debtors	26,150	Bills Payable	900
Cash	2,430	Short-term Loans	2,600
Payments in Advance	3,100	Provision for Taxation	6,200
Bills Receivable	1,130	Proposed Dividend	4,313
Advance Income-tax	5,000		
	51,450		34,300

(3) Payment in advance and Advance income tax cannot be converted into cash. Therefore, these are not to be treated as quick assets.

Illustration 3

(i) From the given data as on 31.3.2016, calculate the Quick Ratio for Mr. Johnson :	₹
Debtors	30,000
Outstanding Expenses	17,000
Cash	23,000
Bills Payable and Creditors	38,000

Income Earned but not Received	6,000
Long-term Loan	23,000
Bills Receivable	7,000
Pre-paid Expenses	4,000

(ii) Based on the significance of the Quick Ratio worked out from the above data, answer in one word. Is it 'Adequate' or 'Inadequate' ?

Solution

(i) $\text{Quick Ratio} = \dfrac{\text{Quick Assets}}{\text{Current Liabilities}} = \dfrac{66{,}000 \text{ (Note 1)}}{55{,}000 \text{ (Note 2)}} = 1.2 : 1$

(ii) It is 'adequate'.

Working Notes :

(1) Quick Assets	₹	(2) Current Liabilities	₹
Debtors	30,000	Outstanding Expenses	17,000
Cash	23,000	Bills Payable and Creditors	38,000
Income Earned but not Received	6,000		55,000
Bills Receivable	7,000		
	66,000		

Prepaid expenses have not been included in the Quick Assets, because they cannot be converted into cash to meet immediate liabilities.

Illustration 4

Current Ratio — 2 : 1, Acid Test Ratio — 0.75 : 1; Current Liabilities ₹ 1,50,000. Calculate Closing Inventories.

Solution

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2:1$$

Or, $\dfrac{\text{Current Assets}}{1{,}50{,}000} = \dfrac{2}{1}$ Or, Current Assets = ₹ 1,50,000 × 2 = ₹ 3,00,000

$\text{Acid Test Ratio} = \dfrac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = 0.75:1$ Or, $\dfrac{3{,}00{,}000 - \text{Stock}}{1{,}50{,}000} = \dfrac{0.75}{1}$

Or, ₹ 3,00,000 – Inventories = ₹ 1,50,000 × 0.75 Or, Inventories = ₹ 3,00,000 – ₹ 1,12,500 = ₹ **1,87,500**

Illustration 5

A firm has current ratio of 4 : 1 and quick ratio of 2.5 : 1. Assuming inventories are ₹ 22,500, find out the total current assets and total current liabilities.

Solution

$\text{Current Ratio} = \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = 4:1$ Or, $\dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{4}{1}$ Or, Current Assets = 4 × Current Liabilities

$\text{Quick Ratio} = \dfrac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}} = 2.5:1$ Or, $\dfrac{4 \text{ Current Liabilities} - 22{,}500}{\text{Current Liabilities}} = \dfrac{2.5}{1}$

Or, 4 Current Liabilities – ₹ 22,500 = 2.5 Current Liabilities Or, 4 Current Liabilities – 2.5 Current Liabilities = ₹ 22,500

Or, 1.5 Current Liabilities = ₹ 22,500 Or, $\text{Current Liabilities} = \dfrac{22{,}500}{1.5} =$ ₹ 15,000

Therefore, Current Assets = 4 Current Liabilities = 4 × ₹ 15,000 = ₹ **60,000**

Illustration 6

A business has a current ratio of 3 : 1. Its net working capital is ₹ 4,00,000 and its Inventories are valued at ₹ 2,50,000. Calculate Quick Ratio.

Solution

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 3:1 \quad \text{Or, } \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{3}{1}$$

Or, Current Assets = 3 × Current Liabilities . . . (1)
Again, Net Working Capital = Current Assets – Current Liabilities
Or, ₹ 4,00,000 = Current Assets – Current Liabilities Or, Current Assets = ₹ 4,00,000 + Current Liabilities . . . (2)

Putting (2) into (1)

₹ 4,00,000 + Current Liabilities = 3 Current Liabilities

Or, 3 Current Liabilities – Current Liabilities = ₹ 4,00,000 Or, Current Liabilities = ₹ 2,00,000

Therefore, Current Assets = 3 × Current Liabilities

= 3 × ₹ 2,00,000 = ₹ 6,00,000

$$\text{Now, Quick Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

$$= \frac{6,00,000 - 2,50,000}{2,00,000} = \frac{3,50,000}{2,00,000} = \frac{7}{4} = 7:4 : 1.75:1$$

Illustration 7

A business has current ratio 3 : 1 and quick ratio 1.2 : 1. If the working capital is ₹ 1,80,000, calculate the current liabilities and inventories.

Solution

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 3:1 \quad \text{Or, } \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{3}{1}$$

Or, Current Assets = 3 × Current Liabilities . . . (1)
Again, Working Capital = Current Assets – Current Liabilities
Or, ₹ 1,80,000 = Current Assets — Current Liabilities Or, Current Assets = ₹ 1,80,000 + Current Liabilities . . . (2)

Putting (2) into (1)
₹ 1,80,000 + Current Liabilities = 3 Current Liabilities
Or, 3 Current Liabilities – Current Liabilities = ₹ 1,80,000
Or 2 Current Liabilities = ₹ 1,80,000
Or, Current Liabilities = ₹ 1,80,000 / 2 = ₹ 90,000
Therefore, Current Assets = ₹ 1,80,000 + Current Liabilities
= ₹ 1,80,000 + ₹ 90,000 = ₹ 2,70,000

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = 1.2:1 \quad \text{Or, } \frac{2,70,000 - \text{Stock}}{90,000} = \frac{1.2}{1}$$

Or, ₹ 2,70,000 – Inventories = 1.2 × ₹ 90,000 Or, Inventories = ₹ 2,70,000 – ₹ 1,08,000 = ₹ **1,62,000**

Illustration 8

From the following, ascertain liquid assets and current liabilities —
Current Ratio 3 : 1; Quick Ratio 1 : 1; Current Assets ₹ 90,000.

Solution

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 3:1 \quad \text{Or,} \frac{90{,}000}{\text{Current Liabilities}} = \frac{3}{1}$$

Or, 3 Current Liabilities = ₹ 90,000

Or, Current Liabilities = ₹ 90,000 / 3 = ₹ 30,000

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = 1:1 \quad \text{Or,} \frac{90{,}000 - \text{Stock}}{30{,}000} = \frac{1}{1}$$

Or, ₹ 90,000 – Inventories = ₹ 30,000 Or, Inventories = ₹ 60,000

Liquid Assets = Current Assets – Inventories

= ₹ 90,000 – ₹ 60,000 = ₹ 30,000

Illustration 9

A firm had current assets of ₹ 1,50,000. It then paid a current liability of ₹ 30,000. After this payment, the current ratio was 2 : 1. Determine the size of the current liabilities and working capital after and before the payment was made.

Solution

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

After the payment

$$\text{Or,} \frac{1{,}50{,}000 - 30{,}000}{\text{Current Liabilities}} = 2:1 \quad \text{Or,} \frac{1{,}50{,}000 - 30{,}000}{\text{Current Liabilities}} = \frac{2}{1}$$

Or, 2 Current Liabilities = ₹ 1,50,000 – ₹ 30,000 = ₹ 1,20,000 Or, Current Liabilities = ₹ 1,20,000 / 2 = ₹ 60,000

Working Capital = Current Assets – Current Liabilities = (₹ 1,50,000 – ₹ 30,000) – ₹ 60,000 = ₹ 60,000

Before the payment

Current Liabilities = Current Liabilities after payment + ₹ 30,000 = ₹ 60,000 + ₹ 30,000 = ₹ 90,000

Working Capital = Current Assets before payment – Current Liabilities before payment

= ₹ 1,50,000 – ₹ 90,000 = ₹ 60,000

Illustration 10

The current ratio of a company is 2 : 1. State, giving reasons, which of the following would improve, reduce, or not change the ratio :

(a) repayment of a current liability; (b) purchasing goods for cash;
(c) sale of office equipment for ₹ 4,000 (book value ₹ 5,000);
(d) sale of goods ₹ 11,000 (cost ₹ 10,000)
(e) payment of dividend.

Solution **Statement Showing the Effect of Different Items on Current Ratio**

Item	Effect on Current Ratio	Reasons
(a)	Improve	After repayment of a current liability, both the total of current assets and total of current liabilities will be reduced by the same amount. Therefore, the current ratio will improve.
(b)	No Change	Purchasing goods for cash will not change the total of current assets, because cash will be replaced by inventories. However, the current liabilities will remain same. Therefore, the current ratio will not change.
(c)	Improve	Sale of office equipment for ₹ 4,000 will increase the total of current assets but current liabilities will remain same. Therefore, the current ratio will improve.
(d)	Improve	Sale of goods for ₹ 11,000 (cost ₹ 10,000) will increase the total of current assets by ₹ 1,000 but the total of current liabilities will remain same. Therefore, the current ratio will improve.
(e)	Improve	Payment of dividend will reduce the total of current assets and the total of current liabilities by the same amount. Therefore, the current ratio will improve.

Illustration 11

The quick ratio of a company is 1.5 : 1. State, giving reasons, which of the following would improve, reduce, or not change the ratio :

(a) Purchase of inventories for cash;
(b) Cash collected from debtors;
(c) Sale of goods (costing ₹ 40,000) for ₹ 50,000;
(d) Sale of an office typewriter (book value ₹ 10,000) for ₹ 8,000.

Solution **Statement Showing the Effect of Different Items on Quick Ratio**

Item	Effect on Quick Ratio	Reasons
(a)	Reduce	Goods purchased for cash will reduce the total of quick assets. Therefore, the quick ratio will reduce.
(b)	No change	Cash collected from debtors will not change the total of quick assets because one quick asset will be replaced by another. Therefore, the quick ratio will not change.
(c)	Improve	Sale of goods for cash will increase the total of the quick assets. Therefore, the quick ratio will improve.
(d)	Improve	Sale of typewriter for ₹ 8,000 will increase the total of quick assets. Therefore, the quick ratio will improve.

Illustration 12

The current ratio of a company is 3 : 1. State, giving reasons, which of the following would improve, reduce, or not change the ratio :

(a) Repayment of long-term loans;
(b) Goods purchased on credit of 2 months;
(c) Purchase of computer for accounts department on credit card, allowed by the vendor 3 months;
(d) Purchase of land by issuing debentures;
(e) Sale of goods for ₹ 15,000 on credit of 1 month (cost of goods sold ₹ 12,000);
(f) Cash collected from debtors;
(g) Cash paid to creditors;
(h) Payment of outstanding liabilities;
(i) Sale of goods for cash ₹ 10,000 (cost ₹ 12,000);
(j) Issue of shares for cash;
(k) Bills receivable drawn on debtors for 3 months;
(l) Bills receivable collected at maturity.

Solution **Statement Showing the Effect of Different Items on Current Ratio**

Item	Effect on Current Ratio	Reasons
(a)	Reduce	Repayment of long-term loans will reduce the total of current assets. However, the total of current liabilities will remain same. Therefore, the current ratio will reduce.
(b)	Reduce	Goods purchased on credit will increase the total of current assets and the total of current liabilities by the same amount. Therefore, the current ratio will reduce.
(c)	Reduce	Purchase of computer on credit which will be paid within 3 months will reduce the total of current assets. However, the total of current liabilities will remain same. Therefore, the current ratio will reduce.
(d)	No change	Purchase of land by issuing debentures will not affect the total of current assets or current liabilities. Therefore, the current ratio will remain same.
(e)	Improve	Sale of goods at a profit will increase the total of current assets. However, the total of current liabilities will remain same. Therefore, the current ratio will improve.
(f)	No change	Cash collected from debtors will not change the total of current assets because one current asset will be replaced by another. But the total of current liabilities will remain same. Therefore, there will be no change in the current ratio.
(g)	Improve	Cash paid to creditors will reduce the total of current assets and current liabilities by the same amount. Therefore, the current ratio will improve.
(h)	Improve	Payment of outstanding liabilities will reduce the total of current assets and current liabilities. Therefore, the current ratio will improve.

(i)	Reduce	Sale of goods at a loss will reduce the total of current assets but the total of current liabilities will remain same. Therefore, the current ratio will reduce.
(j)	Improve	Issue of shares for cash will increase the total of current assets but the total of current liabilities will remain same. Therefore, the current ratio will improve.
(k)	No change	Bills receivable drawn on debtors will not change the total of current assets because one current asset will be replaced by another. Therefore, it will not change the current ratio.
(l)	No change	Bills receivable collected at maturity will not change the total of current assets because one current asset will be replaced by another. Therefore, the current ratio will not change.

Illustration 13

The current ratio of a company is 2.5 : 1. State, giving reasons, which of the following would improve, reduce, or not change the ratio :

(a) Declaration of a final dividend;
(b) Issue of bonus shares out of profits;
(c) Bills receivable endorsed in favour of a creditor;
(d) Endorsed bill dishonoured;
(e) Bills receivable dishonoured at maturity;
(f) Bills payable accepted for 2 months;
(g) Bills payable paid at maturity;
(h) Fully convertible debentures (FCD) converted into equity shares;
(i) Redemption of preference shares out of proceeds from fresh issue of shares.

Solution **Statement Showing the Effect of Different Items on Current Ratio**

Item	Effect on Current Ratio	Reasons
(a)	Reduce	Declaration of a final dividend will increase the total of current liabilities but the current assets will remain same. Therefore, current ratio will reduce.
(b)	No change	Issue of bonus share will not change the total of current assets or current liabilities. Therefore, the current ratio will remain same.
(c)	Improve	Endorsement of bills receivable in favour of creditors will reduce the total of current assets and the current liabilities by the same amount. Therefore, the current ratio will improve.
(d)	Reduce	Endorsed bill dishonoured will increase debtors and creditors by the same amount. Therefore, the current ratio will reduce.
(e)	No change	Bills receivable dishonoured will not change the total of current assets because one current asset will be replaced by another. Therefore, the current ratio will remain same.
(f)	No change	Bills payable accepted will not change the total of current liabilities because one current liability will be replaced by another. Therefore, the current ratio will remain same.
(g)	Improve	Bills payable paid at maturity will reduce the total of the current assets and current liabilities. Therefore, the current ratio will improve.
(h)	No change	Conversion of debentures into shares will not change the total of current assets and current liabilities. Therefore, the current ratio will remain same.
(i)	No change	Redemption of preference shares by issuing new shares will not change the total of current assets (assuming that the proceeds received and the amount paid on redemption are same). Therefore, the current ratio will remain same.

Solvency Ratios

In a popular sense, solvency means that a business is able to pay its liabilities as they become due. Insolvency means the business is unable to do so. Whereas liquidity refers to the ability of a firm to meet its short-term liabilities, solvency usually refers to the firm's ability to meet ***long-term liabilities***. Solvency depends on the profitability of the business. If a business is not profitable in the long-run, it will not be able to meet its debts. Solvency ratios measure the extent to which the firm has been financed by debt. Following are the important solvency ratios :

Debt Equity Ratio

Meaning of debt equity ratio : It is the ratio between long-term debts and shareholders' funds. Long-term debts include debentures, loan from financial institutions, etc. Shareholders' funds include equity and preference share capital *plus* reserves and surplus *minus* fictitious assets (e.g., debit balance of the Profit and Loss Account or discount on issue of shares, etc.)

Formula to Learn

$$\text{Debt Equity Ratio} = \frac{\text{Long–term Debts}}{\text{Shareholders' Funds}}$$

Significance of debt equity ratio : This ratio measures the contribution of ***lenders*** relative to the contribution of ***owners***. Debt equity ratio is also used as a measure of debt exposure, i.e., the extent to which the firm has been financed by debt. This ratio should generally be less than one since it will show that the claims of the owners are greater than those of the lenders. It is also considered unhealthy for a business to have more debt than equity. If the ratio is more than one, it will indicate a high degree of debt in the capital structure of the firm and, in effect, the risks of the enterprise are to be borne mainly by the lenders.

Illustration 14

From the following, ascertain debt equity ratio — Equity share capital ₹ 2,00,000; General reserve ₹ 1,50,000; 10% Debentures ₹ 1,50,000; Current liabilities ₹ 1,00,000.

Solution

$$\text{Debt Equity Ratio} = \frac{\text{Long–term Debts}}{\text{Shareholders' Funds}} = \frac{\text{10\% Debentures}}{\text{Equity Share Capital + General Reserve}}$$

$$= \frac{1,50,000}{2,00,000 + 1,50,000} = \frac{1,50,000}{3,50,000} = 0.43 : 1$$

Illustration 15

From the following information, calculate the Debt Equity Ratio and Current Ratio : Share capital ₹ 1,50,000; Bills payable ₹ 13,000; Creditors ₹ 57,000; Debentures ₹ 2,75,000; Debtors ₹ 95,000; Bank balance ₹ 45,000; Long-term loan ₹ 1,00,000; General reserve ₹ 20,000.

Solution

$$\text{Debt Equity Ratio} = \frac{\text{Long–term Debts}}{\text{Shareholders' Funds}} = \frac{\text{Debentures + Long–term Loan}}{\text{Share Capital + General Reserve}}$$

$$= \frac{2,75,000 + 1,00,000}{1,50,000 + 20,000} = \frac{3,75,000}{1,70,000} = 2.2 : 1 \text{ (approx)}$$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Debtors + Bank Balance}}{\text{Bills Payable + Creditors}}$$

$$= \frac{95,000 + 45,000}{13,000 + 57,000} = \frac{1,40,000}{70,000} = 2 : 1$$

Illustration 16

From the following information, calculate the Debt Equity Ratio and Current Ratio :

Share capital ₹ 2,50,000; Bills payable ₹ 15,000; Creditors ₹ 45,000; Debtors ₹ 60,000; 12% Debentures ₹ 2,80,000;Bank balance ₹ 30,000; Long-term Loan ₹ 1,10,000; General reserve ₹ 25,000.

Solution

$$\text{Debt Equity Ratio} = \frac{\text{Long–term Debts}}{\text{Shareholders' Funds}} = \frac{\text{Debentures + Long–term Loans}}{\text{Share Capital + General Reserve}}$$

$$= \frac{2,80,000 + 1,10,000}{2,50,000 + 25,000} = \frac{3,90,000}{2,75,000} = 1.42 : 1$$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Debtors} + \text{Bank Balance}}{\text{Bills Payable} + \text{Creditors}}$$

$$= \frac{60,000 + 30,000}{15,000 + 45,000} = \frac{90,000}{60,000} = 1.5 : 1$$

Illustration 17

The Debt Equity Ratio of X Ltd is 1 : 2. Which of the following would increase, decrease or not change the Debt Equity Ratio?

(a) Issue of equity shares;
(b) Cash received from debtors;
(c) Sale of goods on cash basis;
(d) Redemption of debentures;
(e) Purchases of goods on credit.

Solution **Statement Showing the Effect of Different Items on Debt Equity Ratio**

Item	Effect on Debt Equity Ratio	Reasons
(a)	Decrease	Issue of equity shares will increase the shareholders' funds but the long-term debts will remain same. Therefore, the debt equity ratio will decrease.
(b)	No change	Cash received from debtors will not change the amount of long-term debts as well as shareholders' funds. Therefore, the debt equity ratio will remain same.
(c)	No change	Goods sold for cash will not change the amount of long-term debts as well as shareholders' funds. Therefore, the debt equity ratio will remain same.
(d)	Decrease	Redemption of debentures will reduce the long-term debts but the shareholders' funds will remain same. Therefore, the debt equity ratio will decrease.
(e)	No change	Purchase of goods on credit will not change the amount of long-term debts as well as shareholders' funds. Therefore, the debt equity ratio will remain same.

Illustration 18

The Debt Equity Ratio of Reliance Furniture Ltd is 1 : 2. Which of the following would (i) increase, (ii) decrease, (iii) neither increase nor decrease the Debt Equity Ratio :

(a) Issue of debentures; (b) Redemption of debentures for cash; (c) Purchased goods on credit; (d) Cash received from debtors; (e) Conversion of debentures into preference shares.

Solution **Statement Showing the Effect of Different Items on Debt Equity Ratio**

Item	Effect on Debt Equity Ratio	Reasons
(a)	Increase	Issue of debentures will increase the amount of long-term debts but the shareholders' funds will remain same. Therefore, the debt equity ratio will increase.
(b)	Decrease	Redemption of debentures will reduce the long-term debts but the shareholders' funds will remain same. Therefore, the debt equity ratio will decrease.
(c)	No change	Purchase of goods on credit will not change the amount of long-term debts as well as shareholders' funds. Therefore, the debt equity ratio will remain same.
(d)	No change	Cash received for debtors will not change the amount of long-term debts as well as shareholders' funds. Therefore, the debt equity ratio will remain same.
(e)	Decrease	Conversion of debentures into preference shares will reduce the long-term debts and it will increase the shareholders' funds. Therefore, the debt equity ratio will decrease.

Total Assets to Debt Ratio

Meaning of total assets to debt ratio : This ratio shows the relationship between total assets and long-term debts. This ratio measures the proportion of the firm's total assets that are financed by long-term debts. Long-term debts include debentures, bonds and loans from financial institutions

Formula to Learn

$$\text{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long–term Debt}}$$

Significance of total assets to debt ratio : A high ratio represents a large degree of security to lenders for extending long-term loans to the firms. On the other hand, if the ratio is too low, it can be concluded that the firm is using more long-term debts for financing its total assets.

Proprietory Ratio

Meaning of proprietory ratio : It is the ratio between shareholders' funds and total assets. This ratio shows the proportion of total assets of a business financed by shareholders' fund.

Formula to Learn

$$\text{Proprietory Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}}$$

Significance of proprietory ratio : This ratio can be used to ascertain the solvency and financial stability of the firm in the long run. A high proprietory ratio is an indication of large degree of security to the lenders, since this ratio indicates more use of shareholders' funds in acquiring total assets of the business. On the other hand, a low proprietory ratio represents more use of long-term debts in financing total assets of the business. Again, if the ratio is too high, it can be concluded that the firm is not willing to use more debt capital.

Illustration 19

Given below is the Balance Sheet of X Ltd. as at 31st March, 2016:

Balance Sheet of X Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		2,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 14% Debentures		1,00,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		40,000
Bills Payable		10,000
TOTAL		3,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		2,20,000

(2) Current Assets :		
(a) Inventories — Closing		80,000
(b) Trade Receivables — Debtors		30,000
(c) Cash and Cash Equivalents — Cash at Bank		20,000
TOTAL		3,50,000

Calculate the following ratios : (i) Total assets to debt ratio; and (ii) Proprietory ratio.

Solution

$$\text{(i) Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long–term debt}} = \frac{3{,}50{,}000}{1{,}00{,}000} = 3.5:1$$

$$\text{(ii) Proprietory Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}} = \frac{\text{Equity Share Capital}}{\text{Total Assets}} = \frac{2{,}00{,}000}{3{,}50{,}000} = 0.57:1$$

Interest-coverage Ratio

This ratio reflects the number of times that a company's interest charges are covered by its earnings before interest and taxes (EBIT). It is a rough indicator of the long-term solvency of a firm in the sense that it shows the ability of a firm to meet its debt service costs out of current earnings. Failure to meet this obligation can bring legal action by the lenders.

Long-term loans are generally the fixed interest bearing securities in the form of debentures. They carry interest charges which must be paid regularly. The inability to meet such obligation is a negative indicator of firm's solvency. No hard and fast standards for the ratio itself exist; it will be an indicator of long-term solvency if it can cover its debt service costs several times over its current operating income which is considered as a basic source of funds for debt service.

Formula to Learn

$$\text{Interest–coverage Ratio} = \frac{\text{Earnings before Interest and Tax}}{\text{Interest Charges}}$$

Illustration 20

From the following information, calculate the following ratios :

(i) Debt Equity Ratio; (ii) Proprietory Ratio; (iii) Total Assets to Debt Ratio.

Balance Sheet of Armstrong Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each fully paid		15,00,000
(b) Reserves and Surplus — General Reserve		6,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		5,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		2,00,000
(b) Trade Payables — Sundry Creditors		12,00,000
TOTAL		40,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		16,50,000
(b) Non-current Investments		1,60,000

(2) Current Assets :		
(a) Inventories		9,10,000
(b) Trade Receivables — Book Debts		12,40,000
(c) Cash and Cash Equivalents — Cash in Hand		40,000
TOTAL		40,00,000

Solution

(i) Debt Equity Ratio $= \dfrac{\text{Long–term Debts}}{\text{Shareholders' Funds}} = \dfrac{\text{Debentures}}{\text{Equity Share Capital + General Reserve}} = \dfrac{5,00,000}{21,00,000} = 0.238 : 1$

(ii) Proprietory Ratio $= \dfrac{\text{Shareholders' Funds}}{\text{Total Assets}} = \dfrac{\text{Equity Share Capital + General Reserve}}{\text{Total Assets}} = \dfrac{21,00,000}{40,00,000} = 0.525 : 1$

(iii) Total Assets to Debt Ratio $= \dfrac{\text{Total Assets}}{\text{Long–term debt}} = \dfrac{40,00,000}{5,00,000} = 8 : 1$

Activity (Assets Utilisation) Ratios

Generally, activity means a particular direction in which a business applies its efforts, e.g., a business may have a trading activity or a manufacturing activity. In accounting, activity is a measure of the general level of business. Thus a firm with a small turnover may be said to be operating at a low level of activity.

Activity ratios show the degree of assets utilisation of a business. Activity ratios are the ratios of the cash elasticity of current assets, i.e., how quickly various current assets are converted into sales and cash. Current assets normally comprise cash, debtors and inventories. A firm's ability to meet current liabilities largely depends upon the rate at which cash flows into the business from current operations. Since Sales (Revenue from Operation) is the critical event in this respect, the rate at which inventories are sold or debtors settle their accounts are very crucial. Thus, it is necessary to evaluate the activity of specified current assets like inventories, debtors and also total assets.

The ***important activity ratios*** are :

(a) Inventories / Stock Turnover Ratio
(b) Debtors Turnover Ratio
(c) Creditors Turnover Ratio
(d) Working Capital Turnover Ratio
(e) Total Assets Turnover Ratio.

Inventories / Stock Turnover Ratio

Meaning of inventories / stock turnover ratio :

It is the ratio of cost of goods sold to average inventories. The inventories turnover ratio measures how quickly inventory is sold, i.e., the number of times a business's inventories turnover during a year. Inventories / Stock turnover is computed by dividing the cost of goods sold by average inventory.

This ratio is likely to differ substantially from one business to another. One important reason is the valuation of inventories. As compared to sales, cost of goods sold is preferable as the numerator but it may not be available to external users.

Formula to Learn

$$\text{Inventory/Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \text{Number of Times}$$

Notes :

(1) Cost of goods sold = Sales – Gross Profit

OR

Cost of goods sold = Opening Inventories + Purchases + Carriage Inwards + Direct Expenses – Closing Inventories

(2) When both sales and inventories fluctuate widely from month to month, a misleading ratio could result from companies year end inventories with the cost of goods sold. One solution would be to use an average inventories. Average inventories is calculated as follows:

Method 1 : $\text{Average Inventory} = \dfrac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$

OR

Method 2 : $\text{Average Stock} = \dfrac{\text{Total of Monthly Stocks}}{12}$

(The information to calculate average inventories by the method 2 is rarely available in examination questions. Therefore, it is better to follow method 1.)

Significance of inventories turnover ratio : Other things remaining the same, an increase in the speed of inventories turnover indicates a relatively low level of Inventories and that increases profits. Conversely, the decline in the inventories turnover indicates the inventoriesing of goods, and slow moving Inventories signify that they are high relative to usage. A too large closing inventories may indicate that sales volume was not as high as expected near year-end, or possibly because of an unusually high sales volume expected near the beginning of the next period.However, the nature of the company's business obviously affects its speed of inventories turnover. ***For example***, a super market can move its inventories faster than a car dealer.

The validity of the inventories turnover ratio depends on the assumption that cost of goods sold is wholly the cost of materials drawn from the inventories. If it includes any amount of labour or overhead they would have to be excluded. Another important point is that inventories turnover is an average figure and may conceal important differences between the type of inventories and another. For example, there may be some obsolete goods in hand which are not actually worth their stated values. Therefore, it is better to do separate calculations for inventories turnover for different types of materials.

Average age of inventories is expressed in days by dividing 365 by the number of times inventories turnover in a year. It is computed as follows.

$$\text{Average age of Stock} = \frac{365}{\text{Stock Turnover}}$$

The inventories turnover in days measures the expected time between purchase of the Inventories and the sales of those Inventories. A high holding period shows a potentially greater risk of obsolescence.

Illustration 21

Calculate the inventories turnover ratio from the following : Opening inventories ₹ 29,000; Closing inventories ₹ 31,000; Sales ₹ 3,20,000; Gross profit ratio 25% on sales.

Solution

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold (Note 1)}}{\text{Average Stock (Note 2)}} = \frac{2{,}40{,}000}{30{,}000} = 8 \text{ Times}$$

Working Notes :

(1) Gross profit is 25% sales = 25% of ₹ 3,20,000 = ₹ 80,000.

Cost of goods sold = Sales – Gross Profit = ₹ 3,20,000 – ₹ 80,000 = ₹ 2,40,000.

(2) $\text{Average Stock} = \dfrac{\text{Opening Stock} + \text{Closing Stock}}{2}$

$$= \frac{29{,}000 + 31{,}000}{2} = ₹\ 30{,}000$$

Illustration 22

Calculate inventories turnover ratio from the following details :

Annual sales ₹ 2,00,000; Gross profit 25% on cost; Opening inventories ₹ 38,500; Closing inventories ₹ 41,500.

Solution

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold (Note 1)}}{\text{Average Stock (Note 2)}} = \frac{1{,}60{,}000}{40{,}000} = 4 \text{ Times}$$

Working Notes : ₹

(1) Let Cost be = 100

Add : Profit 25% = 25

Therefore, Sales = 125

When Sales is ₹ 125, then profit = ₹ 25

When Sales is Re 1 then profit = ₹ 25 / ₹ 125

When Sales is ₹ 100 then (₹ 25 × ₹ 100) / ₹ 125 = ₹ 20 (i.e., G.P. is 20% of sales).

Cost of Goods Sold = Sales – Gross Profit

= ₹ 2,00,000 – 20% of ₹ 2,00,000

= ₹ 2,00,000 – ₹ 40,000 = ₹ 1,60,000.

(2) $\text{Average Stock} = \dfrac{\text{Opening Stock + Closing Stock}}{2} = \dfrac{38{,}500 + 41{,}500}{2} = ₹\ 40{,}000$

Illustration 23

Following figures have been extracted from Shivalika Mills Ltd. :

Inventories at the beginning of the year — ₹ 60,000.

Inventories at the end of the year — ₹ 1,00,000.

Inventories turnover ratio — 8 times. Selling price 25% above cost.

Compute the amount of gross profit and sales.

Solution

$$\text{Average Stock} = \frac{\text{Opening Stock + Closing Stock}}{2}$$

$$= \frac{60{,}000 + 1{,}00{,}000}{2} = ₹\ 80{,}000$$

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = \frac{\text{Cost of Goods Sold}}{80{,}000} = 8$$

Or, Cost of Goods Sold = ₹ 80,000 × 8 = ₹ 6,40,000.

Gross Profit = 25% of ₹ 6,40,000 = ₹ 1,60,000.

Therefore, Sales = Cost of Goods Sold + Gross Profit = ₹ 6,40,000 + ₹ 1,60,000 = ₹ 8,00,000.

Illustration 24

From the following details, calculate (i) Opening inventories; (ii) Closing inventories.

Inventories turnover ratio — 6 times; Gross profit — 20% on sales; Sales — ₹ 1,80,000; Closing inventories is ₹ 15,000 in excess of Opening inventories.

Solution

Gross profit is 20% on sales and sales are ₹ 1,80,000.

Therefore, gross profit is 20% on ₹ 1,80,000 = ₹ 36,000.

Cost of Goods Sold = Sales – Gross Profit

Or, Cost of Goods Sold = ₹ 1,80,000 – ₹ 36,000 = ₹ 1,44,000

Let Opening Inventories = x

Then, Closing Inventories = x + ₹ 15,000

Therefore, Average Inventories = {x + (x + ₹ 15,000)} / 2 = (2x + ₹ 15,000) / 2 = x + ₹ 7,500.

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = 6 \text{ (Given)}$$

$$\Rightarrow \frac{1{,}44{,}000}{x + 7{,}500} = 6$$

⇒ ₹ 1,44,000 = 6x + ₹ 45,000

⇒ 6x = ₹ 1,44,000 – ₹ 45,000

⇒ 6x = ₹ 99,000

⇒ x = Opening Inventories = ₹ 99,000 / 6 = ₹ 16,500.

Therefore, closing inventories is ₹ 16,500 + ₹ 15,000 = ₹ 31,500.

Illustration 25

Calculate the current assets of a company from the following information :

(i) Inventories Turnover Ratio — 5 times.
(ii) Inventories at the end is ₹ 15,000 more than the inventories in the beginning.
(iii) Sales ₹ 2,00,000.
(iv) Gross profit ratio — 25%.
(v) Current liabilities — ₹ 50,000.
(vi) Quick ratio — 0.75.

Solution

Sales ₹ 2,00,000; Gross profit ratio 25%. Therefore, gross profit is 25% of ₹ 2,00,000 = ₹ 50,000. In effect, cost of goods sold is ₹ 2,00,000 – ₹ 50,000 = ₹ 1,50,000.

Let Opening Inventories = x

Then, Closing Inventories = x + ₹ 15,000

Therefore, Average Inventories = {x + (x – ₹ 15,000)} / 2 = (2x + ₹ 15,000) / 2 = x + ₹ 7,500.

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = 5 \text{ (Given)}$$

$$\Rightarrow \frac{1,50,000}{x + 7,500} = 5$$

⇒ 5x + ₹ 37,500 = ₹ 1,50,000
⇒ 5x = ₹ 1,50,000 – ₹ 37,500
⇒ 5x = ₹ 1,12,500
⇒ x = Opening Inventories = ₹ 22,500.

Therefore, closing inventories is ₹ 22,500 + ₹ 15,000 = ₹ 37,500.

$$\text{Again, Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = \text{Or, } 0.75 = \frac{\text{Quick Assets}}{50,000}$$

Or, Quick Assets = ₹ 50,000 × 0.75 = ₹ 37,500.

Therefore, Current Assets = Quick Assets + Closing Inventories = ₹ 37,500 + ₹ 37,500 = ₹ 75,000.

Illustration 26

A trader carries an average inventories of ₹ 40,000 (cost). His inventories turnover is 8 times. If he sells goods at a profit of 20% on sales, find out his profit.

Solution

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = \frac{\text{Cost of Goods Sold}}{40,000} = 8 \text{ (Given)}$$

Or, Cost of Goods Sold = ₹ 40,000 × 8 = ₹ 3,20,000.

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$\text{Or, } 20 = \frac{\text{Net Sales} - \text{Cost of Goods Sold}}{\text{Net Sales}} \times 100$$

$$\text{Or, } 20 = \frac{\text{Net Sales} - 3,20,000}{\text{Net Sales}} \times 100$$

$$\text{Or, } \frac{20}{100} = \frac{\text{Net Sales} - 3,20,000}{\text{Net Sales}} \quad \text{Or, } \frac{1}{5} = \frac{\text{Net Sales} - 3,20,000}{\text{Net Sales}}$$

Or, Net Sales = 5 Net Sales – ₹ 16,00,000.
Or 5 Net Sales – Net Sales = ₹ 16,00,000
Net Sales = ₹ 16,00,000 / 4 = ₹ 4,00,000.
Therefore, profit is 20% on sales = 20% on ₹ 4,00,000 = ₹ 80,000.

Debtors Turnover Ratio

Meaning of debtors turnover ratio This is the ratio between the credit sales (if the information in regard to credit sales is not available, total sales may be taken in place of credit sales) and average debtors *plus* average bills receivable. This ratio indicates the number of times per year that the average balance of debtors are collected.

Formula to Learn

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Trade Receivables (Average Debtors + Average Bills Receivable)}}$$

$$= \text{Number of Times Debtors Collected each year}$$

Significance of debtors turnover ratio A high debtors turnover ratio may indicate an improvement in business conditions, a tightening of credit policies, or improved collection procedures. A low ratio may be an indication of long credit period or slow realisation from debtors.

Debt Collection Period : It provides a rough approximation of the average time taken to collect from the debtors. It is computed by dividing 365/12 by the number of debtors turnover. It is determined as follows :

$$\textit{Debt Collection Period} = \frac{365}{\textit{Debtors' Turnover}} = \textit{Number of Days}$$

$$\textit{Debt Collection Period} = \frac{12}{\textit{Debtors' Turnover}} = \textit{Number of Months}$$

The debtors turnover ratio and debt collection period are often used to measure a business's ability to meet short-term obligations and measure the strength of the business's current operations. In other words, they can be used as indicators of how quickly the debtors are converted into cash required for operations and debt repayment.

Illustration 27

Calculate Debtors' Turnover Ratio and Average Collection Period in terms of months from the following :

Credit sales for the year ₹ 60,000; Debtors ₹ 5,000; Bills Receivable ₹ 5,000.

Solution

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Trade Receivables (Average Debtors + Average Bills Receivable)}}$$

$$= \frac{60{,}000}{5{,}000 + 5{,}000} = \frac{60{,}000}{10{,}000} = 6 \text{ Times}$$

$$\text{Average Collection Period} = \frac{12}{\text{Debtors' Turnover}} = \frac{12}{6} = 2 \text{ months}$$

Illustration 28

From the following information, calculate Debtors Turnover Ratio and Average Collection Period :

Opening debtors ₹ 37,000; Closing debtors ₹ 43,000; Sales ₹ 6,00,000; Cash sales ₹ 80,000.

Solution

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Debtors}} = \frac{5{,}20{,}000 \text{ (Note 1)}}{40{,}000 \text{ (Note 2)}} = 13 \text{ Times}$$

$$\text{Average Collection Period} = \frac{365}{\text{Debtors' Turnover}} = \frac{365}{13} = 28 \text{ days (approx.)}$$

Working Notes :

(1) Credit Sales = ₹ 6,00,000 – ₹ 80,000 = ₹ 5,20,000.

(2) Average Debtors = (Opening debtors+Closing debtors)/2 = (₹ 37,000 + ₹ 43,000)/2 = ₹ 40,000.

Illustration 29

Compute the Debtors Turnover Ratio from the following :

Particulars	2014 Year 1 (₹)	2015 Year 2 (₹)
Gross Sales	9,00,000	7,50,000
Debtors at the beginning of the year	83,000	1,17,000
Debtors at the end of the year	1,17,000	83,000
Sales Returns	1,00,000	50,000

Solution

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Debtors}} = \overset{\text{Year 1}}{\frac{8,00,000}{1,00,000}} = 8 \text{ Times}; = \overset{\text{Year 2}}{\frac{7,00,000}{1,00,000}} = 7 \text{ Times}$$

Working Notes	Year 1	Year 2
Credit Sales (Gross Sales – Sales Returns)	₹ 9,00,000 – ₹ 1,00,000 = ₹ 8,00,000	₹ 7,50,000 – ₹ 50,000 = ₹ 7,00,000
Average Debtors = (Opening Debtors + Closing Debtors) / 2	(₹ 83,000 + ₹ 1,17,000) / 2 = ₹ 1,00,000	(₹ 1,17,000 + ₹ 83,000) / 2 = ₹ 1,00,000

Illustration 30

From the following details, calculate Debtors Turnover Ratio :

	₹
Total sales for the year	1,75,000
Cash sales 20% of total Sales	
Sales return — out of credit sales	10,000
Sundry Debtors —	
Opening balance	8,000
Closing balance	12,000

Solution

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Debtors}} = \frac{1,30,000 \text{ (Note 1)}}{10,000 \text{ (Note 2)}} = 13 \text{ Times}$$

Working Notes :

(1) Cash Sales is 20% of total sales. Therefore, credit sales are 80% of total sales = 80% of ₹ 1,75,000 = ₹ 1,40,000.
Net credit sales = ₹ 1,40,000 – ₹ 10,000 (sales return) = ₹ 1,30,000.

(2) Average Debtors = (Opening debtors + Closing debtors) / 2 = (₹ 8,000 + ₹ 12,000) / 2 = ₹ 10,000.

Illustration 31

Calculate the amount of opening debtors and closing debtors from the following figures :

Debtors turnover ratio — 4 times.
Cost of goods sold — ₹ 6,40,000.
Gross profit ratio — 20%.
Closing debtors were ₹ 20,000 more than at the beginning.
Cash sales being $33^1/_3$ of credit sales.

Solution

Cost of goods sold = ₹ 6,40,000. Gross profit ratio = 20%.
Therefore, cost of goods sold is 80% of sales.
In effect, Sales = ₹ 6,40,000 / 80% = ₹ 8,00,000.
Total sales = cash sales + credit sales

Let us assume x = credit sales
Therefore, according to the given conditions : ₹ 8,00,000 = x + x/3
$\Rightarrow$ 4x/3 = ₹ 8,00,000
$\Rightarrow$ x = Credit Sales = ₹ 8,00,000 x 3/4 = ₹ 6,00,000.

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Debtors}}$$

$$\Rightarrow 4 = \frac{6,00,000}{\frac{y + (y + 20,000)}{2}}$$ [Assuming y is opening debtors]

$$\Rightarrow 4 = \frac{6,00,000}{\frac{2y + 20,000}{2}}$$

$$\Rightarrow 4 = \frac{6,00,000}{y + 10,000}$$

$\Rightarrow$ 4y = ₹ 5,60,000
$\Rightarrow$ y = ₹ 5,60,000 / 4 = ₹ 1,40,000.
Therefore, opening debtors is ₹ 1,40,000 and closing debtors is ₹ 1,40,000 + ₹ 20,000 = ₹ 1,60,000.

Creditors Turnover Ratio

Meaning of creditors turnover ratio : This is the ratio between the credit purchases (if the information in regard to credit purchases is not available, total purchases may be taken in place of credit purchases) and average creditors *plus* average bills payable. This ratio indicates the number of times per year that the average balance of creditors are paid.

Formula to Learn

$$\text{Creditors Turnover Ratio} = \frac{\text{Credit Purchases}}{\text{Trade Payables (Average Creditors + Average Bills Payable)}}$$

$$= \text{Number of Times Creditors are Paid each year}$$

Significance of creditors turnover ratio : A high creditors turnover ratio may indicate strict credit terms granted by the suppliers. A low ratio may be an indication of liberal credit terms granted by the suppliers.

Average Payment Period : It provides a rough approximation of the average time taken to pay back the creditors. It is computed by dividing 365 or 12 by the number of creditors turnover. It is determined as follows:

$$\textit{Debt Payment Period} = \frac{365}{\textit{Creditors' Turnover}} = \textit{Number of Days}$$

$$\textit{Debt Payment Period} = \frac{12}{\textit{Creditors' Turnover}} = \textit{Number of Months}$$

Working Capital Turnover Ratio

Meaning of working capital turnover ratio : This is the ratio between turnover (sales) and working capital (current assets less current liabilities). This ratio shows the extent to which a business is using its working capital to generate sales.

Formula to Learn

$$\text{Working Capital Turnover Ratio} = \frac{\text{Net Sales / Turnover}}{\text{Working Capital}} = \text{Number of Times}$$

Significance of working capital turnover ratio : This ratio indicates the number of times the working capital has been turned over or utilised during the period. A high ratio indicates efficient use of working capital in generating sales. A low ratio is an indication of inefficiency of working capital management.

Illustration 32

From the following Balance Sheet of Avinash Ltd, you are required to calculate Working Capital Turnover Ratio.

Balance Sheet of Avinash Ltd. as at 31st March, 2016

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid			5,00,000
(b) Reserves and Surplus — General Reserve			2,00,000
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			—
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors			2,20,000
Bills Payable			1,30,000
(b) Other Short-term Provision — Provision for Taxation			1,50,000
TOTAL			12,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Plant and Machinery	5,00,000		
Less: Accumulated depreciation	1,00,000		4,00,000
(2) Current Assets :			
(a) Current Investments			1,00,000
(b) Inventories			1,00,000
(c) Trade Receivables — Sundry Debtors			2,00,000
Bills Receivables			1,50,000
(d) Cash and Cash Equivalents — Cash at Bank			2,50,000
TOTAL			12,00,000

(i) Total sales during the year ₹ 31,00,000.
(ii) Sales return during the year ₹ 1,00,000.

Solution

$$\text{Working Capital Turnover Ratio} = \frac{\text{Turnover (Note 1)}}{\text{Working Capital (Note 2)}} = \frac{30,00,000}{3,00,000} = 10 \text{ Times}$$

Working Notes :

(1) Turnover = Total sales less return inwards = ₹ 31,00,000 – ₹ 1,00,000 = ₹ 30,00,000.

(2) Working capital = current assets – current liabilities

Current assets = Short-term investments + Inventories + Sundry debtors + Bills receivable + Cash at bank + Cash in hand
= ₹ 1,00,000 + ₹ 1,00,000 + ₹ 2,00,000 + ₹ 1,50,000 + ₹ 1,50,000 + ₹ 1,00,000 = ₹ 8,00,000.

Current liabilities = Sundry Creditors + Bills Payable + Provision for Income Tax
= ₹ 2,20,000 + ₹ 1,30,000 + ₹ 1,50,000 = ₹ 5,00,000.

Therefore, working capital = ₹ 8,00,000 – ₹ 5,00,000 = ₹ 3,00,000.

Total Assets Turnover Ratio

Meaning of total assets turnover ratio : It is the ratio of sales to total assets. It is intended to reflect the intensity with which assets are employed. This ratio focuses on the use of assets made by a company and it is considered to be a prime determinant of the level of future income inflows.

Formula to Learn

$$\text{Total Assets Turnover Ratio} = \frac{\text{Net Sales / Turnover}}{\text{Total Assets}} = \text{Number of Times}$$

Significance of total assets turnover ratio : A low ratio indicates that the assets are not being efficiently employed. A high ratio indicates that the assets are being utilised efficiently.

Illustration 33

From the following Balance Sheet of Avinash Ltd, you are required to calculate :
(i) Working Capital Turnover Ratio; and (ii) Total Assets Turnover Ratio.

Balance Sheet of Avinash Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each fully paid		5,00,000
(b) Reserves and Surplus — General Reserve		2,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		2,20,000
Bills Payable		30,000
(b) Other Short-term Provision — Provision for Income Tax		50,000
TOTAL		10,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		4,00,000
(2) Current Assets :		
(a) Current Investments		1,00,000
(b) Inventories		1,00,000
(c) Trade Receivables — Sundry Debtors		2,00,000
Bills Receivables		50,000
(d) Cash and Cash Equivalents — Cash at Bank		1,50,000
TOTAL		10,00,000

(i) Total sales during the year ₹ 31,00,000.
(ii) Sales return during the year ₹ 1,00,000.

Solution

$$\text{Working Capital Turnover Ratio} = \frac{\text{Net Sales / Turnover (Note 1)}}{\text{Working Capital (Note 2)}} = \frac{30,00,000}{3,00,000} = 10 \text{ Times}$$

$$\text{Total Assets Turnover Ratio} = \frac{\text{Net Sales / Turnover}}{\text{Total Assets}} = \frac{30,00,000}{10,00,000} = 3 \text{ Times}$$

Working Notes :

(1) Turnover = Total sales less return inwards = ₹ 31,00,000 – ₹ 1,00,000 = ₹ 30,00,000.

(2) Working capital = current assets – current liabilities

Current assets = Short-term investments + Inventories + Sundry debtors + Bills receivable + Cash at bank + Cash in hand
= ₹ 1,00,000 + ₹ 1,00,000 + ₹ 2,00,000 + ₹ 50,000 + ₹ 50,000 + ₹ 1,00,000 = ₹ 6,00,000.

Current liabilities = Sundry Creditors + Bills Payable + Provision for Income Tax
= ₹ 2,20,000 + ₹ 30,000 + ₹ 50,000 = ₹ 3,00,000.

Therefore, working capital = ₹ 6,00,000 – ₹ 3,00,000 = ₹ 3,00,000.

Profitability Ratios

The key interest of the owners of a business, e.g., the equity shareholders in the case of a company is the profitability. Profitability means the returns achieved through the efforts of the management on the funds invested by the owners of a business. The amount of profits earned by a business has little significance unless it is related to its source.

Profitability is the capacity of an enterprise to make profits as measured by accounting ratios relating profit to sales or to investment. It is the net result of a large number of policies and decisions. Profitability ratios measure management's overall efficiency as shown by the returns generated on sales and investments.

The ***important profitability ratios*** are :

(i) Gross Profit Ratio
(ii) Net Profit Ratio
(iii) Return on Capital Employed
(iv) Return on Networth
(v) Operating Ratio

Gross Profit Ratio

Meaning of gross profit ratio : This is the ratio between gross profit and net sales. The gross profit is the difference between net sales and cost of goods sold (i.e., the direct cost of sales). Net sales means total sales *less* returns. This ratio is expressed as a percentage of sales.

Formula to Learn

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Significance of gross profit ratio : The more the gross profit earned, the better. This is because from the gross profit the company must cover its operating and other expenses — what is left after that will be the net profit. It measures the efficiency of production / purchase as well as pricing.

Prices are often fixed so as to give a standard gross profit percentage, so a fluctuation in the gross profit as a percentage of sales can indicate errors or fraud affecting the sales, purchases or inventories figures. This ratio is thus used a lot by those especially concerned with errors or fraud — management, auditors and tax authorities.

Illustration 34

From the following information, calculate Gross Profit Ratio.

Net sales ₹ 3,00,000; Cost of goods sold ₹ 2,00,000; Net profit ₹ 30,000.

Solution

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{1{,}00{,}000 \text{ (Note 1)}}{3{,}00{,}000} \times 100 = 33\frac{1}{3}\%$$

Working Note : (1) Gross Profit = Net Sales – Cost of Goods Sold
= ₹ 3,00,000 – ₹ 2,00,000 = ₹ 1,00,000.

Illustration 35

From the following figures pertaining to two companies — A Ltd and B Ltd., belonging to plastic industry, calculate the Gross Profit Ratio of the two companies.

Which company is doing better ?

	A Ltd (₹)	B Ltd (₹)		A Ltd (₹)	B Ltd (₹)
Net Profit after interest	75,000	10,000	Sales (Gross)	3,30,000	3,80,000
Indirect Expenses	10,000	15,000	Sales (Returns)	10,000	20,000
Interest paid on Debentures	15,000	25,000			

Solution

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$\text{A Ltd.} = \frac{1{,}00{,}000 \text{ (Note 1)}}{3{,}20{,}000 \text{ (Note 2)}} \times 100 = 31.25\%;$$

$$\text{B Ltd.} = \frac{50{,}000 \text{ (Note 1)}}{3{,}60{,}000 \text{ (Note 2)}} \times 100 = 13.89\% \text{ (approx)}$$

Comment : Gross profit ratio of A Ltd (31.25%) is better than that of B Ltd (13.89%). Therefore, A Ltd is doing better than B Ltd.

Working Notes :

(1) Calculation of Gross Profit **(2) Calculation of Net Sales**

	A Ltd (₹)	B Ltd (₹)		A Ltd (₹)	B Ltd (₹)
Net Profit after interest	75,000	10,000	Gross Sales	3,30,000	3,80,000
Add : Int. paid on debentures	15,000	25,000	Less : Sales returns	10,000	20,000
Add : Indirect expenses	10,000	15,000			
	1,00,000	50,000		3,20,000	3,60,000

Illustration 36

From the following information, calculate :

(i) Gross Profit Ratio; (ii) Inventories Turnover Ratio; and (iii) Debtors Turnover Ratio: Sales ₹ 1,50,000; Cost of Goods Sold ₹ 1,20,000; Opening Inventories ₹ 27,000; Closing Inventories ₹ 33,000; Debtors ₹ 14,000; Bills Receivable ₹ 6,000.

Solution

$$\text{(i) Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{\text{Sales} - \text{Cost of Goods Sold}}{\text{Sales}} \times 100$$

$$= \frac{1{,}50{,}000 - 1{,}20{,}000}{1{,}50{,}000} \times 100 = \frac{30{,}000}{1{,}50{,}000} \times 100 = 20\%$$

$$\text{(ii) Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = \frac{1{,}20{,}000}{30{,}000 \text{ (Note 1)}} = 4 \text{ Times}$$

$$\text{(iii) Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Debtors} + \text{Average Bills Receivable}}$$

$$= \frac{1{,}50{,}000 \text{ (Note 3)}}{20{,}000 \text{ (Note 2)}} = 7.5 \text{ Times}$$

Working Notes :

(1) Average Inventories = (₹ 27,000 + ₹ 33,000) / 2 = ₹ 30,000.

(2) Debtors + Bills Receivable = ₹ 14,000 + ₹ 6,000 = ₹ 20,000.

(3) It is assumed that all are credit sales.

Illustration 37

On the basis of the following information, calculate :

(i) Gross Profit Ratio; (ii) Working Capital Turnover Ratio; and (iii) Debt Equity Ratio.

Net Sales ₹ 30,00,000; Cost of Goods Sold ₹ 20,00,000; Current Assets ₹ 6,00,000; Current Liabilities ₹ 2,00,000; Paid-up Share Capital ₹ 5,00,000; Debentures ₹ 2,50,000; Loan ₹ 1,25,000.

Solution

$$\text{(i) Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{\text{Net Sales} - \text{Cost of Goods Sold}}{\text{Net Sales}} \times 100$$

$$= \frac{30{,}00{,}000 - 20{,}00{,}000}{30{,}00{,}000} \times 100 = \frac{10{,}00{,}000}{30{,}00{,}000} \times 100 = 33.33\%$$

$$\text{(ii) Working Capital Turnover Ratio} = \frac{\text{Turnover}}{\text{Working Capital}}$$

$$= \frac{\text{Turnover}}{\text{Current Assets} - \text{Current Liabilities}}$$

$$= \frac{30{,}00{,}000}{6{,}00{,}000 - 2{,}00{,}000} = \frac{30{,}00{,}000}{4{,}00{,}000} = 7.5 \text{ Times}$$

$$\text{(iii) Debt Equity Ratio} = \frac{\text{Long–term Debts}}{\text{Shareholders' Funds}} = \frac{\text{Debenture} + \text{Loans}}{\text{Share Capital}}$$

$$= \frac{2{,}50{,}000 + 1{,}25{,}000}{5{,}00{,}000} = \frac{3{,}75{,}000}{5{,}00{,}000} = 0.75 : 1$$

Illustration 38

From the following information, calculate : (i) Inventories Turnover; and (ii) Gross Profit Ratio.

Opening Inventories ₹ 18,000; Closing Inventories ₹ 22,000; Purchases ₹ 46,000; Wages ₹ 14,000; Sales ₹ 80,000; Carriage Inwards ₹ 4,000.

Solution

$$\text{(i) Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} = \frac{\text{Rs } 60{,}000 \text{ (Note 1)}}{\text{Rs } 20{,}000 \text{ (Note 2)}} = 3 \text{ Times}$$

$$\text{(ii) Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{20{,}000 \text{ (Note 3)}}{80{,}000} \times 100 = 25\%$$

Working Notes :

(1) Cost of Goods Sold = Opening Inventories + Purchases + Wages + Carriage Inwards – Closing Inventories
= ₹ 18,000 + ₹ 46,000 + ₹ 14,000 + ₹ 4,000 – ₹ 22,000 = ₹ 60,000.

(2) Average Inventories = (Opening Inventories + Closing Inventories) / 2
= (₹ 18,000 + ₹ 22,000) / 2 = ₹ 20,000.

(3) Gross Profit = Sales – Cost of Goods Sold = ₹ 80,000 – ₹ 60,000 = ₹ 20,000

Net Profit Ratio

Meaning of net profit ratio : This is the ratio between net profit and net sales. Net profit is the excess of total sales of a given accounting period over total expenses. This ratio seeks to assess the profitability of sales.

Formula to Learn

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

Significance of net profit ratio : A good net profit margin indicates management's ability to operate the business with sufficient success not only to cover the cost of production, the operating expenses including depreciation, and the debt service costs, but also to leave a margin of reasonable compensation to the owners — who have provided funds to the business at a risk.

Illustration 39

From the following particulars, you are requested to compute : (i) Current Ratio; (ii) Net Profit Ratio; (iii) Gross Profit Ratio:

Inventories ₹ 50,000; Debtors ₹ 40,000; Bills Receivable ₹ 10,000; Advances Paid ₹ 4,000; Cash in Hand ₹ 30,000; Creditors ₹ 60,000; Bills Payable ₹ 40,000; Bank Overdraft ₹ 4,000; Sales (net) ₹ 7,00,000; Gross Profit ₹ 50,000; Net Profit ₹ 30,000.

Solution

$$\text{(i) Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1{,}34{,}000 \text{ (Note 1)}}{1{,}04{,}000 \text{ (Note2)}} = 1.29 : 1$$

$$\text{(ii) Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \frac{30{,}000}{7{,}00{,}000} \times 100 = 4.29\%$$

[It is not in the CBSE New Syllabus.]

$$\text{(iii) Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{50{,}000}{7{,}00{,}000} \times 100 = 7.14\%$$

Working Notes :

(1) Current Assets = Inventories + Debtors + Bills Receivable + Advance Paid + Cash in Hand
= ₹ 50,000 + ₹ 40,000 + ₹ 10,000 + ₹ 4,000 + ₹ 30,000 = ₹ 1,34,000.

(2) Current Liabilities = Creditors + Bills Payable + Bank Overdraft
= ₹ 60,000 + ₹ 40,000 + ₹ 4,000 = ₹ 1,04,000.

Illustration 40

From the following data, calculate the following ratios : (i) Gross Profit Ratio; (ii) Net Profit Ratio; (iii) Current Ratio; and (iv) Debt Equity Ratio.

Net sales ₹ 30,000; Cost of sales ₹ 20,000; Net profit ₹ 3,000; Current assets ₹ 6,000; Inventories ₹ 1,000; Current liabilities ₹ 2,000; Paid-up share capital ₹ 5,000; Debentures ₹ 2,500.

Solution

$$\text{(i) Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}} \times 100$$

$$= \frac{30{,}000 - 20{,}000}{30{,}000} \times 100 = \frac{10{,}000}{30{,}000} \times 100 = 33\frac{1}{3}\%$$

$$\text{(ii) Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \frac{3{,}000}{30{,}000} \times 100 = 10\%$$

$$\text{(iii) Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{6{,}000}{2{,}000} = 3 : 1$$

$$\text{(iv) Debt Equity Ratio} = \frac{\text{Long–term Debts}}{\text{Shareholders' Funds}} = \frac{2{,}500}{5{,}000} = 0.5 : 1$$

Illustration 41

From the following data, calculate : (i) Gross Profit Ratio; and (ii) Working Capital Turnover Ratio:

Net sales ₹ 30,00,000; Cost of sales ₹ 20,00,000; Current assets ₹ 6,00,000; Current liabilities ₹ 2,00,000; Paid-up share capital ₹ 5,00,000.

Solution

(i) Gross Profit Ratio $= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}} \times 100$

$$= \frac{30,00,000 - 20,00,000}{30,00,000} \times 100 = \frac{10,00,000}{30,00,000} \times 100 = 33.33\%$$

(ii) Working Capital Turnover Ratio $= \frac{\text{Turnover}}{\text{Working Capital}}$

$$= \frac{\text{Turnover}}{\text{Current Assets} - \text{Current Liabilities}}$$

$$= \frac{30,00,000}{6,00,000 - 2,00,000} = \frac{30,00,000}{4,00,000} = 7.5 \text{ Times}$$

Illustration 42

Following is the Balance Sheet of Hindusthan Products Ltd. as on 31st March, 2016 :

Balance Sheet of Hindusthan Products Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each fully paid		2,90,000
(b) Reserves and Surplus — Profit and Loss account		60,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		1,15,000
(b) Other Current Liabilities — Outstanding Expenses		15,000
TOTAL		4,80,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets — Land		2,30,000
(2) Current Assets :		
(a) Inventories		1,99,000
(b) Trade Receivables — Sundry Debtors		21,000
(d) Cash and Csh Equivalents — Cash in Hand		30,000
TOTAL		4,80,000

Additional information :

(i) Sales / Revenue from Operations — ₹ 8,00,000.
(ii) Gross Profit — ₹ 3,40,000.
(iii) Opening Stock — ₹ 99,000.
(iv) Closing Stock — ₹ 1,99,000.

Calculate the following ratios : (i) Quick Ratio; and (ii) Inventories Turnover Ratio.

Solution

(i) Quick Ratio $= \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = \frac{\text{Cash + Debtors}}{\text{Creditors + Outstanding Expenses}}$

$$= \frac{30,000 + 21,000}{1,15,000 + 15,000} = \frac{51,000}{1,30,000} = 0.39 : 1$$

(ii) Stock Turnover Ratio $= \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$

$$= \frac{4,60,000 \text{ (Note 1)}}{1,49,000 \text{ (Note 2)}} = 3.09 \text{ Times (approx.)}$$

Working Notes :

(1) Cost of Goods Sold = Sales – Gross Profit = ₹ 8,00,000 – ₹ 3,40,000 = ₹ 4,60,000.

(2) Average Inventories = (Opening Inventories + Closing Inventories) / 2
= (₹ 99,000 + ₹ 1,99,000) / 2 = ₹ 1,49,000.

Operating Ratio

Meaning of operating ratio : This is the ratio between 'cost of goods sold plus operating expenses' and net sales. It measures the proportion of operating expenses per rupee of sales. It is expressed as a percentage of sales.

Cost of Goods Sold = Sales *less* Gross Profit

OR

= Opening Inventories + Purchases + Direct Expenses + Wages – Closing Inventories

Operating Expenses = Administrative Expenses + Selling and Distribution Expenses

Formula to Learn

$$\text{Operating Ratio} = \frac{\text{Cost of Goods Sold + Operating Expenses}}{\text{Net Sales}} \times 100$$

Significance of operating ratio : A high operating ratio indicates a small surplus available to the business and, in effect, a lower profitability. The lower the ratio, the greater the ability to carry a large burden of fixed overheads.

Illustration 43

Following is the Trading and Profit and Loss Account of a sole proprietorship firm for the year ended 31.3.2016:

Dr. Profit and Loss Account Cr.

Particulars	₹	Particulars	₹
To Inventories	35,000	By Sales	4,00,000
To Purchases	2,25,000	By Inventories at end	50,000
To Wages	6,000		
To Gross Profit c/d	1,84,000		
	4,50,000		4,50,000
To Administrative Expenses	10,000	By Gross Profit b/d	1,84,000
To Selling and Distribution Expenses	14,000		
To Loss on Sale of Plant	10,000		
To Net Profit	1,50,000		
	1,84,000		1,84,000

Calculate operating ratio.

Solution

$$\text{Operating Ratio} = \frac{\text{Cost of Goods Sold + Operating Expenses}}{\text{Net Sales}} \times 100$$

$$\text{OperatingRatio} = \frac{2,16,000 + 24,000}{4,00,000} \times 100 = \frac{2,40,000}{4,00,000} \times 100 = 60\%$$

Cost of Goods Sold = Opening Inventories + Purchases + Wages – Closing Inventories
= ₹ (35,000 + 2,25,000 + 6,000 – 50,000) = ₹ 2,16,000

Operating Expenses = Administration Expenses + Selling and Distribution Expenses
= ₹ (10,000 + 14,000) = ₹ 24,000

Tutorial Note : Loss on sale of plant will not be taken into consideration for calculating operating ratio.

Illustration 44

Given below is the Trading, Profit and Loss Account and Balance Sheet of a sole proprietorship business. :

Dr. Trading, Profit and Loss Account for the year ended 31.3.2016 Cr.

Particulars	₹	Particulars	₹
To Opening Inventories	40,000	By Sales	3,20,000
To Purchases	2,60,000	By Closing Inventories	80,000
To Gross Profit	1,00,000		
	4,00,000		4,00,000
To Selling Expenses	12,000	By Gross Profit	1,00,000
To Office Expenses	8,000		
To Depreciation	6,000		
To Interest on Debentures	14,000		
To Income Tax	20,000		
To Net Profit	40,000		
	1,00,000		1,00,000

Balance Sheet as on 31.3.2016

Liabilities	₹	Assets	₹
Equity Share Capital	2,00,000	Cash	20,000
14% Debentures	1,00,000	Debtors	30,000
Bills Payable	10,000	Closing Inventories	80,000
Creditors	40,000	Fixed Assets	2,20,000
	3,50,000		3,50,000

Calculate the following ratios :
(a) Operating Ratio; (b) Quick Ratio; and (c) Inventories Turnover Ratio.

Solution

$$\text{(a) Operating Ratio} = \frac{\text{Cost of goods sold + Operating Expenses}}{\text{Net Sales}} \times 100$$

$$= \frac{\text{Rs } 2{,}20{,}000 + \text{Rs } 26{,}000 \text{ (Note 2)}}{\text{Rs } 3{,}50{,}000} \times 100 = \frac{2{,}46{,}000}{3{,}20{,}000} \times 100 = 76.875\%$$

$$\text{(b) Quick Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = \frac{\text{Cash + Debtors}}{\text{Bills Payable + Creditors}}$$

$$= \frac{20{,}000 + 30{,}000}{10{,}000 + 40{,}000} = \frac{50{,}000}{50{,}000} = 1:1$$

[**Note** : Closing inventories will not be treated as a quick asset.]

$$\text{(c) Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold (Note 1)}}{\text{Average Stock (Note 3)}}$$

$$= \frac{2{,}20{,}000}{60{,}000} = 3.67 \text{ Times (approx.)}$$

Working Notes :

(1) Cost of Goods Sold = Sales – Gross Profit = ₹ 3,20,000 – ₹ 1,00,000 = ₹ 2,20,000.
(2) Operating Expenses = Selling Expenses + Office Expenses + Depreciation = ₹ 12,000 + ₹ 8,000 + ₹ 6,000 = ₹ 26,000.
(3) Average Inventories = (Opening Inventories + Closing Inventories) / 2 = (₹ 40,000 + ₹ 80,000) / 2 = ₹ 60,000.

Illustration 45

The operating ratio of a company is 80%. State, giving reasons, which of the following transactions will (a) increase; (b) decrease; or (c) not alter the operating ratio :

	₹
(i) Credit purchases of goods	5,000
(ii) Sales returns	200

(iii) Payment to creditors	1,000
(iv) Selling expenses	800
(v) Cash sales	10,000
(vi) Purchase returns	100

Solution **Statement Showing the Effect of Different Items on Operating Ratio**

Item	Effect on Operating Ratio	Reasons
(i)	Increase	Purchases of goods ₹ 5,000 will increase the cost of goods sold which, in turn, will increase operating ratio.
(ii)	Increase	Sales return ₹ 200 will decrease the amount of net sales by ₹ 200. Therefore, the operating ratio will increase.
(iii)	No Effect	Payment to creditors ₹ 1,000 will not affect any of the components of cost of goods sold or operating expenses or net sales. Therefore, operating ratio will remain same.
(iv)	Increase	Selling expenses ₹ 800 will increase operating expenses. Therefore, operating ratio will increase.
(v)	Decrease	Cash sales ₹ 10,000 will increase net sales. Therefore, operating ratio will decrease.
(vi)	Decrease	Purchase returns ₹ 100 will decrease net purchases, in effect it will reduce cost of goods sold. Therefore, operating ratio will decrease.

Illustration 46

From the following data calculate :

(1) Current ratio; and (ii) Operating ratio.

Sundry debtors — ₹ 10,000; Bills payable — ₹ 6,000; Inventories – ₹ 15,000; Cash — ₹ 10,000; Bank — ₹ 5,000; Creditors — ₹ 14,000; Sales — ₹ 60,000; Operating expenses — ₹ 12,000; Cost of goods sold — ₹ 18,000.

Solution

(i) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{40{,}000 \text{ (Note 1)}}{20{,}000 \text{ (Note 2)}} = 2 : 1$

(ii) Operating Ratio $= \dfrac{\text{Cost of goods sold + Operating Expenses}}{\text{Net Sales}} \times 100$

$$= \frac{18{,}000 + 12{,}000}{60{,}000} \times 100 = 50\%$$

Working Notes :

(1) Current Assets	₹	(2) Current Liabilities	₹
Sundry Debtors	10,000	Bills Payable	6,000
Inventories	15,000	Creditors	14,000
Cash	10,000		
Bank	5,000		
	40,000		20,000

Illustration 47

Calculate the following ratios, from the details given as under :

(i) Current ratio;
(ii) Acid test ratio;
(iii) Operating ratio; and
(iv) Gross profit ratio.

Liquid assets — ₹ 40,000; Current liabilities — ₹ 20,000; Inventories — ₹ 10,000; Sales — ₹ 50,000; Operating expenses — ₹ 15,000; Cost of goods sold — ₹ 20,000.

Solution

(i) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{\text{Liquid Assets + Stock}}{\text{Current Liabilities}}$

$$= \frac{40{,}000 + 10{,}000}{20{,}000} = 5 : 2 \text{ or } 2.5 : 1$$

(ii) Acid Test Ratio $= \dfrac{\text{Liquid Assets}}{\text{Current Liabilities}} = \dfrac{40{,}000}{20{,}000} = 2:1.$

(iii) Operating Ratio $= \dfrac{\text{Cost of goods sold + Operating Expenses}}{\text{Net Sales}} \times 100$

$= \dfrac{20{,}000 + 15{,}000}{50{,}000} \times 100 = 70\%$

(iv) Gross Profit Ratio $= \dfrac{\text{Gross Profit}}{\text{Sales}} \times 100 = \dfrac{\text{Sales} - \text{Cost of Goods Sold}}{\text{Sales}} \times 100$

$= \dfrac{50{,}000 - 20{,}000}{50{,}000} \times 100 = \dfrac{30{,}000}{50{,}000} \times 100 = 60\%$

Illustration 48

Dr. Trading, Profit and Loss Account of Himanshu for the year ended 31st December, 2015 Cr.

Particulars	₹	Particulars	₹
To Opening Inventories	1,52,500	By Sales	10,01,000
To Purchases	6,30,500	By Inventories-in-Trade	1,96,000
To Carriage Inwards	4,000		
To Wages	10,000		
To Gross Profit	4,00,000		
	11,97,000		11,97,000
To Administrative Expenses	2,02,000	By Gross Profit	4,00,000
To Salaries and Distribution Expenses	24,000	By Non-operating Income	12,000
To Financial Expenses	14,000		
To Non-operating Expenses	4,000		
To Net Profit	1,68,000		
	4,12,000		4,12,000

Balance Sheet of Himanshu as at 31st December, 2015

Liabilities	₹	Assets	₹
Capital	7,00,000	Fixed Assets	6,01,000
Reserve	12,000	Inventories-in-Trade	1,96,000
Profit and Loss Account	1,68,000	Debtors	90,000
Bank Loan	7,000	Bank	30,000
Creditors	30,000		
	9,17,000		9,17,000

Calculate : (i) Gross profit ratio; (ii) Operating ratio; (iii) Current ratio; and (iv) Liquidity ratio.

Solution

(i) Gross Profit Ratio $= \dfrac{\text{Gross Profit}}{\text{Sales}} \times 100 = \dfrac{4{,}00{,}000}{10{,}01{,}000} \times 100 = 39.96\%$

(ii) Operating Ratio $= \dfrac{\text{Cost of goods sold + Operating Expenses}}{\text{Sales}} \times 100$

$= \dfrac{6{,}01{,}000 + 2{,}26{,}000 \text{ (Note 1)}}{10{,}01{,}000} \times 100 = 82.62\%$

(iii) Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{3{,}16{,}000 \text{ (Note 2)}}{37{,}000 \text{ (Note 1)}} = 8.54:1$

$$\text{(iv) Liquidity Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

$$= \frac{3,16,000 - 1,96,000}{37,000} = \frac{1,20,000}{37,000} = 3.24 : 1$$

Working Notes :

(1) Operating Expenses = Administrative Expenses + Selling and Distribution Expenses
= ₹ 2,02,000 + ₹ 24,000 = ₹ 2,26,000.
(Financial expenses and non-operating expenses are to be ignored.)

(2) Current Assets = Inventories-in-trade + Debtors + Bank = ₹ 1,96,000 + ₹ 90,000 + ₹ 30,000 = ₹ 3,16,000.

(3) Current Liabilities = Bank Loan + Creditors = ₹ 7,000 + ₹ 30,000 = ₹ 37,000.

Return on Capital Employed

Meaning of return on capital employed : It is the relationship between Earning Before Interest and Tax (EBIT) and Capital Employed. The shareholders and long-term fund providers are very concerned about the rate of return on capital employed. It measures how well the firm is using all of its assets — both those provided by its owner and those provided by its lenders. Capital employed includes — shareholders' funds and long-term loan. The value of this ratio usually is expressed as a percentage.

Formula to Learn

$$\text{Return on Capital Employed (ROCE)} = \frac{\text{EBIT}}{\text{Capital Employed}} \times 100$$

Significance of return on capital employed : The higher the ratio, the more favourable the interpretation of the firm's ability to use of available resources to generate income.

EBIT = Earning / Profit before Interest and Tax.

Capital Employed = Share Capital + Reserve and Surplus – Fictitious Assets + Long-term Loans

Illustration 49

From the following information, calculate Return on Capital Employed	₹
(a) Share capital (2,00,000 equity shares of ₹ 10 each)	20,00,000
(b) General Reserve	15,00,000
(c) Profit and Loss Account balance	5,00,000
(d) 15% Debentures	30,00,000
(e) Profit before Tax	14,00,000
(f) Provision for Tax	5,00,000

Solution

$$\text{Return on Capital Employed (ROCE)} = \frac{\text{EBIT}}{\text{Capital Employed}} \times 100$$

$$= \frac{18,50,000}{70,00,000} \times 100 = 26.43\%$$

Working Notes :

(1) Capital Employed

	₹
Share Capital	20,00,000
General Reserve	15,00,000
Profit and Loss Account	5,00,000
Networth	40,00,000
Add: 15% Debentures	30,00,000
	70,00,000

(2) EBIT (Earning before Interest and Tax)

	₹
Profit before Tax	14,00,000
Add: Debentures Interest @ 15% on ₹ 30,00,000	4,50,000
	18,50,000

(3) Profit after Tax

	₹
Profit before tax	14,00,000
Less: Tax	5,00,000
	9,00,000

Return on Networth / Equity

Meaning of return on networth / equity : It is the ratio of net profit after tax to networth. It measures the rate of return on the resources provided by the shareholders. Networth includes share capital and reserve and surplus (after adjusting fictitious assets).

Formula to Learn

$$\text{Return on Networth / Equity} = \frac{\text{Profit after Tax}}{\text{Networth}} \times 100$$

Significance of return on networth / equity : This ratio measures the amount of earnings for each rupee that the equity shareholders have invested in the company. The higher the ratio the more favourable is the interpretation of the company's use of its resources contributed by the equity shareholders. A company can increase the return of the equity shareholders through the favourable use of debts.

Gearing Ratio

Long-term capital of a business is provided by different group of investors (e.g., shareholders, debentureholders, etc.). Gearing is a method of comparing how much of the long-term capital of a business is provided by equity (equity shares + reserve and surplus – fictitious assets) and how much is provided by fixed charge capital investors who are entitled to interest or dividend before equity shareholders can have a dividend for themselves. The gearing ratio is a measure of financial risk.

Gearing ratio is important when a company wants to raise additional ***loan capital***. If it is a high geared company, then the would-be lenders might take the view that equity shareholders should provide a fair proportion of the total capital for the business and at present they are not doing so. The would-be lenders might be worried that profits are not sufficient to meet future payment of interest.

Formula to Learn

The most usual method of measuring ***Gearing Ratio*** are :

(a) $$\frac{\text{Fixed Charge Capital (Long–term Loans + Preference Shares)}}{\text{Equity (Equity Share Capital + Reserve – Fictitious Assets)}} \times 100$$

Notes :
(i) A business is low-geared if the gearing is less than 100
(ii) A business is neutrally geared if the gearing is equal to 100.
(iii) A business is high-geared if the gearing is more than 100.

(b) $$\frac{\text{Fixed Charge Capital (Long–term Loans + Preference Shares Capital)}}{\text{Total Long–term Capital}} \times 100$$

Notes :
(i) A business is low-geared if the gearing is less than 50
(ii) A business is neutrally geared if the gearing is equal to 50.
(iii) A business is high-geared if the gearing is more than 50.

Market Value / Investors' Ratios

Market value ratios are used to appraise the performance of companies in terms of share prices and yields. Although the earnings efficiency is a very important indicator of a company's overall performance it has to be related to its prices. The important market value ratios are as under :

Earnings Per Share (EPS)

It is the earnings of a company attributable to the equity shareholders divided by the number of equity shares. It is a measure to which both management and shareholders pay a great deal of attention since the results for an accounting period is expressed as earnings per share. This ratio is significant only for equity shareholders.

Formula to Learn

$$\text{Earnings Per Share} = \frac{\text{Net Income after Tax} - \text{Preference Dividend Requirement}}{\text{Number of Equity Shares}}$$

This ratio is used as a basis for predicting the future values of equity shares, since it is generally acknowledged that the market value of ordinary shares is closely related to the earnings per share. Since the number of equity shares is the denominator, its value is related on the number of shares. The use of debt financing or trading on equity makes the earnings per share much more volatile. When the ROI exceeds the debt service costs, debt financing has a favourable impact on EPS. Conversely, when the debt service costs exceeds the ROI, the use of debt financing has an unfavourable impact on EPS. The decline in EPS should be of concern to investors when he seeks to make best allocation of his investment funds.

Price Earnings Ratio (P/E Ratio)

Price-earnings ratio seeks to relate EPS to the current market price of the share. It expresses the market price of the share as a multiple of its annual earnings. It is the reciprocal of the earnings yield multiplied by 100. In effect, price earnings ratio gives the number of rupees paid for one rupee of a company’s annual net income.

Formula to Learn

$$\text{Price Earnings Ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share}}$$

Price earnings ratio is a capitalisation factor. The higher the price earnings ratio, the more the inventories market things of the company and the cheaper the cost of equity capital to the company.

Earning yield

It is the ratio of earnings per share to the market value per equity share. It is expressed in terms of percentage.

Formula to Learn

$$\text{Earning yield} = \frac{\text{EPS}}{\text{Market Value per Share}} \times 100$$

Dividend Ratios

Dividends are generally declared publicly on a per share basis by the Board of Directors of a Company. Equity shareholders are primarily interested in receiving dividends.

The two important ratios are : (a) Dividend yield ratio; and (b) Dividend payment ratio.

(a) ***Dividend yield*** is the ratio between a company’s current dividend per equity share and current market price per equity share.

Formula to Learn

$$\text{Dividend yield} = \frac{\text{Dividend per Share}}{\text{Market Value per Share}} \times 100$$

(b) ***Dividend payment*** is the ratio between dividend per equity share and earning per equity share.

Formula to Learn

$$\text{Dividend payment} = \frac{\text{Dividend per Share}}{\text{Earning per Share}} \times 100$$

GENERAL ILLUSTRATIONS

Calculation of Ratio

Illustration 50

Following is the Balance Sheet of M/s Sure Success Ltd as on 31st March, 2016.

Balance Sheet of M/s Sure Success Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each fuly paid		5,00,000
12% Preference Shares of ₹ 10 each fully paid		5,00,000
(b) Reserves and Surplus — General Reserve		2,00,000
Profit and Loss Account		40,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		2,50,000
(4) Current Liabilities :		
(a) Trade Payables :		
Trade Creditors		4,00,000
Bills Payable		30,000
(b) Short-term Provisions :		
Provision for Tax		2,00,000
Proposed Dividend		1,00,000
(c) Other Current Liabilities : Outstanding Expenses		20,000
TOTAL		22,40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land and Buildings		1,10,000
Plant and Machinery		4,50,000
Furniture		80,000
(ii) Intangible Assets : Goodwill		1,00,000
(2) Current Assets :		
(a) Inventories		7,50,000
(b) Trade Receivables :		
Debtors		6,00,000
Bills Receivable		40,000
(c) Cash and Cash Equivalents : Cash at Bank		1,00,000
(d) Other Current Assets : Prepaid Expenses		10,000
TOTAL		22,40,000

The net sales were ₹ 30,00,000 for the year whereas gross sales were ₹ 30,30,000.
From the above particulars, calculate the following ratios :
(i) Current Ratio; (ii) Liquid Ratio; (iii) Debt-Equity Ratio; and (iv) Working Capital Turnover Ratio.

Solution **Calculation of Ratios**

Name of the Ratio	Method of Computation	Required Ratio
Current Ratio	$\dfrac{\textit{Current Assets}}{\textit{Current Liabilities}}$	$\dfrac{15{,}00{,}000 \text{ (Note 1)}}{7{,}50{,}000 \text{ (Note 2)}} = 2:1$
Liquid Ratio	$\dfrac{\textit{Liquid Assets}}{\textit{Current Liabilities}}$	$\dfrac{7{,}50{,}000 \text{ (Note 3)}}{7{,}50{,}000} = 1:1$
Debt-Equity Ratio	$\dfrac{\textit{Long–term Debts}}{\textit{Shareholders' Equity}}$	$\dfrac{2{,}50{,}000}{12{,}40{,}000 \text{ (Note 5)}} = 0.2:1$
Working Capital Turnover Ratio	$\dfrac{\textit{Sales}}{\textit{Working Capital}}$	$\dfrac{30{,}00{,}000}{7{,}50{,}000 \text{ (Note 6)}} = 4 \text{ Times}$

Working Notes :

(1) Current Assets	₹	**(2) Current Liabilities**	₹
Inventories	7,50,000	Trade Creditors	4,00,000
Debtors	6,00,000	Bills Payable	30,000
Bills Receivable	40,000	Provision for Taxation	2,00,000
Prepaid Expenses	10,000	Proposed Dividends	1,00,000
Cash and Bank	1,00,000	Outstanding Expenses	20,000
	15,00,000		7,50,000
(3) Liquid Assets*		**(4) Long Term Debt**	
Current Assets	15,00,000	12% Debentures	2,50,000
Less: Inventories	7,50,000	**(5) Shareholders' Equity**	
	7,50,000	Equity Shares	5,00,000
*Some accountants exclude prepaid expenses from liquid assets. If it is done, the liquid assets will be (₹ 15,00,000 – 7,60,000) = ₹ 7,40,000.		Preference Shares General Reserves	5,00,000 2,00,000
(6) Working Capital		Profit and Loss Account	40,000
= Current Assets – Current Liabilities = ₹ 7,50,000.			12,40,000

Illustration 51

The following is the Balance Sheet of Prosperous Ltd as on 31st March, 2016 :

Balance Sheet of Prosperous Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital	(1)	70,00,000
(b) Reserves and Surplus — General Reserve Profit and Loss		5,00,000 1,50,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 12% Debentures		20,00,000

(4) Current Liabilities :		
(a) Trade Payables — Trade Creditors		6,00,000
(b) Short-term Provisions :		
Provision for Taxation		2,00,000
Proposed Dividend		3,00,000
(c) Other Current Liabilities — Outstanding Expenses		1,50,000
TOTAL		1,09,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Land		5,00,000
Building		30,00,000
Plant and Machinery		30,00,000
Furniture		4,00,000
(2) Current Assets :		
(a) Inventories		15,00,000
(b) Trade Receivables — Debtors		20,00,000
(c) Cash and Cash Equivalents — Cash		4,00,000
(d) Other Current Assets — Prepaid Expenses		1,00,000
TOTAL		1,09,00,000

Notes to Accounts :

(1) Share Capital

Particulars	(₹)
Issued, Subscribed and Paid-up Capital :	
3,00,000 Equity Shares of ₹ 10 each fully paid	30,00,000
4,00,000 Preference Shares of ₹ 10 each fully paid	40,00,000
	70,00,000

From the above particulars, you are required to calculate :
(i) Current Ratio; (ii) Debt-Equity Ratio; (iii) Capital Gearing Ratio; (iv) Liquid Ratio.

[Delhi University, B.Com. (Hons.) — Adapted]

Solution

Calculation of Ratios

Name of the Ratio	Method of Computation	Required Ratio
(i) Current Ratio	$\frac{Current\ Assets}{Current\ Liabilities}$	$\frac{4,000\ (Note\ 1)}{1,250\ (Note\ 2)} = 3.2 : 1$
(ii) Debt-Equity Ratio	$\frac{Long\text{–}term\ Debts}{Shareholders'\ Equity}$	$\frac{2,000\ (Note\ 4)}{7,650\ (Note\ 3)} = 0.26 : 1$
(iii) Capital Gearing Ratio	$\frac{Long\ term\ Fixed\ Charge\ Capital}{Equity\ Funds}$	$\frac{6,000\ (Note\ 5)}{3,650\ (Note\ 6)} = 1.64 : 1$
(iv) Liquid Ratio	$\frac{Current\ Assets - Stock}{Current\ Liabilities}$	$\frac{2,500}{1,250} = 2 : 1$

Working Notes :

(1) Current Assets	₹ ('000)	(2) Current Liabilities	₹ ('000)
Debtors	2,000	Trade Creditors	600
Inventories	1,500	Outstanding Expenses	150
Cash	400	Provision for Taxation	200
Prepaid Expenses	100	Proposed Dividends	300
	4,000		1,250

(3) Shareholders' Equity		**(5) Long Term Fixed Charge Capital**	
Equity Share Capital	3,000	Preference Share Capital	4,000
Preference Share Capital	4,000	12% Debentures	2,000
General Reserve	500		6,000
Profit and Loss Account	150	**(6) Equity Funds**	
	7,650	Equity Share Capital	3,000
(3) Long Term Debt		General Reserve	500
12% Debenture	2,50,000	Profit and Loss Account	150
			3,650

Illustration 52

The following financial statement in summarised form is from the books of Armstrong Ltd as at 31st March, 2016.

Balance Sheet of Armstrong Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share of ₹ 10 each fully paid		15,00,000
(b) Reserves and Surplus — General Reserve		6,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		5,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		2,00,000
(b) Trade Payables — Sundry Creditors		12,00,000
TOTAL		40,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		16,50,000
(2) Current Assets :		
(a) Current Investments		1,60,000
(b) Inventories		9,10,000
(c) Trade Receivables — Book Debts		12,40,000
(d) Cash and Cash Equivalents — Cash in Hand		40,000
TOTAL		40,00,000

Annual Sales : ₹ 74,40,000; Gross Profit : ₹ 7,44,000.
You are required to calculate the following ratio for the year :
(i) Debt-Equity Ratio; (ii) Current Ratio; (iii) Proprietory Ratio; (iv) G.P. Ratio; (v) Debtors Turnover Ratio; (vi) Inventories Turnover Ratio.
Bank Overdraft is payable on demand.

Solution

Calculation of Ratios

Name of the Ratio	Method of Computation	Required Ratio
(i) Debt-Equity Ratio	$\frac{\textit{Long-term Debts}}{\textit{Shareholder's Equity}}$	$\frac{5,00,000}{21,00,000} = 0.238 : 1$
(ii) Current Ratio	$\frac{\textit{Current Assets}}{\textit{Current Liabilities}}$	$\frac{23,50,000 \text{ (Note 1)}}{14,00,000 \text{ (Note 2)}} = 1.679 : 1$

(iii) Proprietory Ratio	$\frac{\text{Shareholders' Funds}}{\text{Total Assets}}$	$\frac{21,00,000 \text{ (Note 3)}}{40,00,000} = 0.525:1$
(iv) Gross Profit Ratio	$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$	$\frac{7,44,000}{74,40,000} \times 100 = 10\%$
(v) Debtors Turnover Ratio	$\frac{\text{Credit Sales}}{\text{Receivables (Debtors + Bills Receivable)}}$	$\frac{74,40,000}{12,40,000} = 6$ Times
(vi) Inventories Turnover Ratio	$\frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$	$\frac{66,96,000^*}{9,10,000} = 7.358$ Times

*Sales – Gross Profit = ₹ 74,40,000 – ₹ 7,44,000 = ₹ 66,96,000.

Notes to Solution :

(1) In the absence of information, it is assumed that opening inventories and closing inventories are same.

(2) In calculating debtors' turnover ratio, the entire sales has been taken as credit sales.

Working Notes :

(1) Current Assets	₹	(2) Current Liabilities	₹
Inventories	9,10,000	Bank Loan	2,00,000
Book Debts	12,40,000	Sundry Creditors	12,00,000
Investment (short-term)	1,60,000		14,00,000
Cash	40,000	**(3) Shareholders' Fund / Equity**	
	23,50,000	Paid-up Capital	15,00,000
		General Reserve	6,00,000
			21,00,000

Illustration 53

From the following summarised financial statement of Arthur Ltd as on 31st December, 2014 and 31st December, 2015, calculate the following ratios for the two years :

(a) Capital Gearing Ratio; (b) Acid Test Ratio; and (c) Current Ratio.

Balance Sheet of Arthur Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		5,00,000	6,00,000
(b) Reserves and Surplus — Securities Premium		—	20,000
Revenue Reserve		80,000	1,20,000
Profit and Loss Account		1,20,000	1,60,000
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		2,00,000	1,00,000
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		3,50,000	3,70,000
TOTAL		12,50,000	13,70,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets : Freehold Premises		3,00,000	3,00,000
Machinery		3,00,000	3,60,000
Furniture		25,000	34,000

(2) Current Assets :			
(a) Inventories (b) Trade Receivables — Debtors (c) Cash and Cash Equivalents — Cash in Hand		3,20,000 3,00,000 5,000	3,90,000 2,50,000 36,000
TOTAL		12,50,000	13,70,000

Solution **Calculation of Ratios**

Name of the Ratio	Method of Computation	Required Ratio 2010	Required Ratio 2011
(a) Current Ratio	$\dfrac{Current\ Assets}{Current\ Liabilities}$	$\dfrac{6,25,000\ (\text{Note } 1)}{3,50,000} = 1.79:1$	$\dfrac{6,76,000\ (\text{Note } 1)}{3,70,000} = 1.83:1$
(b) Acid Test Ratio	$\dfrac{Current\ Assets - Inventories}{Current\ Liabilities}$	$\dfrac{3,05,000}{3,50,000} = 0.87:1$	$\dfrac{2,86,000}{3,70,000} = 0.77:1$
(c) Capital Gearing Ratio	$\dfrac{Long\ term\ Fixed\ Charge\ Capital}{Equity\ Funds}$	$\dfrac{2,00,000}{7,00,000} = 0.29:1$	$\dfrac{1,00,000}{9,00,000} = 0.11:1$

Working Notes :

(1) Current Assets	2014 (₹)	2015 (₹)	**(2) Current Liabilities**	2014 (₹)	2015 (₹)
Inventories	3,20,000	3,90,000	Sundry Creditors	3,50,000	3,70,000
Debtors	3,00,000	2,50,000	**(3) Long-term Fixed Charge Capital**		
Cash	5,000	36,000	10% Debentures	2,00,000	1,00,000
	6,25,000	6,76,000			
(3) Equity Funds					
Equity Share Capital	5,00,000	6,00,000			
Securities Premium	—	20,000			
Reserve	80,000	1,20,000			
Profit and Loss Account	1,20,000	1,60,000			
	7,00,000	9,00,000			

Illustration 54

The following data has been abstracted from the annual accounts of a company :

Particulars	₹ in Lakhs	Particulars	₹ in Lakhs
Share Capital (20,00,000 Equity Shares of ₹ 10 each)	200	Profit Before Tax	140
General Reserve	150	Provision for Tax	84
Investment Allowance Reserve	50	Proposed Dividend	10
15% Long-term Loan	300		

Calculate, from the above, the following ratios :
(i) Return on Capital Employed; and (ii) Return on Networth. ***[C.A. (Inter) — Adapted]***

Solution **Calculation of Ratios**

Name of the Ratio	Method of Computation	Required Ratio
(a) Return on Capital Employed	$\dfrac{Profit\ before\ interest\ and\ tax}{Capital\ Employed} \times 100$	$\dfrac{185\ (\text{Note } 1)}{700\ (\text{Note } 3)} \times 100 = 26.4\%$
(b) Return on Net Worth	$\dfrac{Profit\ after\ tax\ and\ interest}{Net\ worth} \times 100$	$\dfrac{56\ (\text{Note } 2)}{400\ (\text{Note } 3)} \times 100 = 14\%$

Working Notes :

(1) Profit Before Interest and Tax	₹ in Lakhs	(3) Capital Employed	₹ in Lakhs
Profit before Tax	140	Share Capital	200
Add: Interest @ 15% on Long-term Loan	45	General Reserve	150
	185	Investment Allowance Reserve	50
(2) Profit After Tax		**Net Worth**	400
Profit before tax	140	15% Long-term Loan	300
Less: Provision for tax	84		700
	56		

Illustration 55

Mr T Munim is made an offer by the promoters of Svargiya Enterprises Ltd to invest in the project of the Company by purchasing a substantial portion of the share capital. He is promised good returns by way of dividends and capital appreciation. Mr Munim desires that you compute the following ratios for financial analysis. (i) Return on Investment Ratio; (ii) Net Profit Ratio; (iii) Inventories Turnover Ratio; (iv) Current Ratio; and (v) Debt-Equity Ratio.

Workings should form part of your answer.

The relevant figures are as under :

Particulars	₹ ('000)	Particulars	₹ ('000)
Sales	16,000	Share Capital	5,000
Raw Materials Consumed	7,800	Reserve & Surplus	1,500
Consumables	800	Secured Term Loan	12,000
Direct Labour	750	Unsecured Term Loan	1,500
Other Direct Expenses	480	Trade Creditors	3,350
Administrative Expenses	1,200	Investments	400
Selling Expenses	260	Inventories	6,000
Interest	1,440	Receivables	3,700
Fixed Assets	14,000	Cash in Hand and at Bank	100
Income-tax	50%	Provisions	650
Depreciation	700	Other Current Liabilities	200

Solution **Calculation of Ratios**

Name of the Ratio	Method of Computation	Required Ratio
(i) Return on Investment	$\frac{\textit{Profit before interest and tax}}{\textit{Capital Employed}} \times 100$	$\frac{4{,}010 \text{ (Note 1)}}{20{,}000 \text{ (Note 2)}} \times 100 = 20.05\%$
(ii) Net Profit Ratio	$\frac{\textit{Net Profit}}{\textit{Sales}} \times 100$	$\frac{1{,}285 \text{ (Note 5)}}{16{,}000} \times 100 = 8.03\%$
(iii) Inventories Turnover Ratio	$\frac{\textit{Cost of Goods Sold}}{\textit{Average Stock}}$	$\frac{9{,}830 \text{ (Note 1)}}{6{,}000 \text{ (Note 5)}} = 1.64$ Times
(iv) Current Ratio	$\frac{\textit{Current Assets}}{\textit{Current Liabilities}}$	$\frac{9{,}800 \text{ (Note 3)}}{4{,}200 \text{ (Note 4)}} = 2.33 : 1$
(v) Debt Equity Ratio	$\frac{\textit{Long–term Debts}}{\textit{Shareholders' Equity}}$	$\frac{13{,}500 \text{ (Note 2)}}{6{,}500 \text{ (Note 2)}} = 2.08 : 1$

Assumption : It is assumed that both opening inventories and closing inventories are equal. Therefore, closing inventories = average inventories.

Working Notes :

(1) Computation of Profit before Interest and Tax		₹ in '000	(2) Capital Employed		₹ in '000
Sales		16,000	Share Capital	5,000	
Less: *Direct Cost*			Reserve and Surplus	1,500	
Material consumed	7,800		**Total Shareholders' Equity**		6,500
Consumables	800		Secured Term Loan	12,000	
Direct Labour	750		Unsecured Term Loan	1,500	
Other direct expenses	480	9,830	**Total Long Term Loan**		13,500
Gross Profit		6,170			20,000

Admistrative Expenses	1,200		**(3) Current Assets**	
Selling Expenses	260		Inventories	6,000
Depreciation	700	2,160	Receivables	3,700
Profit before interest and tax		4,010	Cash in Hand and at Bank	100
(5) Computation of Net Profit				9,800
Profit before Interest and Tax (Note 1)		4,010	**(4) Current Liabilities**	
Less: Interest		1,440	Trade Creditors	3,350
Profit after Interest but before Tax		2,570	Provisions	650
Less: Income Tax (50%)		1,285	Other Current Liabilities	200
Net Profit		1,285		4,200

(6) It is assumed that opening inventories and closing inventories are same. Inventories given in the problem is assumed to be closing inventory.

Illustration 56

You are the accounts officer of P Ltd. The company's computerised accounting package produces a monthly Profit Statement and Balance Sheet. The Chief Accountant uses these to prepare a summarised report on the company's performance and financial position and presents this to the Board of Directors.

You have been asked to prepare the report for the month of May, 2016. The statements are given below :

Profit and Loss Accounts for the month of . . .

Particulars	May, 2016 (₹ in Lakhs)	April, 2016 (₹ in Lakhs)
Sales	1,350	1,050
Cost of Goods Sold	552	262
Gross Profit	798	788
Other Operating Costs	360	376
Net Profit	438	412

Balance Sheet at the end of . . .

Particulars	May, 2016		April, 2016	
	(₹ in Lakhs)	(₹ in Lakhs)	(₹ in Lakhs)	(₹ in Lakhs)
Fixed Assets		2,847		2,250
Current Assets (A)				
Inventories	48		330	
Debtors	1,515		1,080	
Bank	—		18	
	1,563		1,428	
Current Liabilities (B)				
Creditors	278		540	
Bank Overdraft	556		—	
	834		540	
Working Capital [A – B]		729		888
Total		3,576		3,138
Equity Share Capital		1,500		1,500
Profit and Loss Account Balance		2,076		1,638
Total		3,576		3,138

You have been given the following additional information :

(i) During May, 2016 the company paid ₹ 600 lakhs for a new piece of machinery purchased during the month. This was financed by a bank credit as a temporary measure. The company will receive the proceeds of a ₹ 600 lakhs long-term loan during July, 2016.

(ii) The sales figure for May includes ₹ 300 lakhs for sales made to a charity at cost price. Apart from supporting the charity's work, this sale generated some valuable publicity for the company. The inventories was all purchased during April, 2016.

(iii) The report should include the following ratios based on the May and April figure:
(a) Gross Profit percentage; (b) Current Ratio; (c) Debtors turnover in days; (d) Creditors turnover in days

These should all allow for the effects of the unusual transactions described in (i) and (ii) above. Inventories was worth ₹ 56 lakhs at the beginning of April, 2016.

Solution

For
The Chief Accountant

Ref : Report for the Month of May, 2016

(a) Gross Profit Percentage $= \frac{\text{Gross Profit}}{\text{Sales}} \times 100$

$$\text{May} : \frac{798}{1{,}350 - 300} \times 100 = 76\% \qquad \text{April} : \frac{788}{1{,}050} \times 100 = 75.05\%$$

(b) Current Ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$

$$\text{May} : \frac{1{,}563 + (600 - 556)}{278} = 5.78 : 1 \qquad \text{April} : \frac{1{,}428}{540} = 2.64 : 1$$

(c) Debtors' Turnover (in days) $= \frac{\text{Debtors}}{\text{Sales}} \times$ Number of days in the month

$$\text{May} : \frac{1{,}515}{1{,}350} \times 31 \text{ days} = 35 \text{ days} \qquad \text{April} : \frac{1{,}080}{1{,}050} \times 30 \text{ days} = 31 \text{ days}$$

(d) Creditors' Turnover (in days) $= \frac{\text{Creditors}}{\text{Purchases}} \times$ Number of days in the month

$$\text{May} : \frac{278}{270 \text{ (Note 1)}} \times 31 \text{ days} = 32 \text{ days} \qquad \text{April} : \frac{540}{536 \text{ (Note 1)}} \times 30 \text{ days} = 30 \text{ days}$$

At the time of calculating gross profit percentage for May, 2016 I have deducted ₹ 300 lakhs sale made to a charity at cost. This has been done to reflect gross profit percentage on normal sales. If the sales for charity is included, the G.P. percentage will be reduced and may give a misleading signal.

At the time of calculating Current Ratio for May, 2016 I have reinstated (to the bank account) ₹ 600 lakhs used to buy new machinery. This is because the financing by way of an overdraft was a temporary measure only, since it will be converted into a long-term loan in July 2016. If this adjustment had not been made, the ratio would have been distorted to look low for two months.

Sincerely yours,
A.O.

Working Notes :

(1) Calculation of Purchasers

Cost of goods sold = Opening inventories + Purchases – Closing Inventories

OR

Purchases = Cost of goods sold – Opening Inventories + Closing Inventories

May : 552 – 330 + 48 = ₹ 270 lakhs April : 262 – 56 + 330 = ₹ 536 lakhs

Illustration 57

The directors of H Ltd are keen to reduce the company's bank overdraft by at least ₹ 6,00,000. They believe that this could be accomplished by better management of company's trade debtors.

In January, 2016 one of the accounts officer submitted a suggestion to finance director that the company should offer trade debtors @ 2% cash discount if they pay for purchases made in March, 2012 before the end of that month. He estimated that 40% of the debtors would take advantage of such an offer, thereby reducing bank overdraft at the Balance Sheet date and reducing debtors turnover in days. His suggestion was rejected partly because of the loss due to discount but mainly because it would make the financial accounts misleading.

The following information has been extracted from the financial statements for the year ended 31st March, 2016 :

Cash sales	₹ 120 lakhs
Credit sales	140 lakhs
Trade debtors	22 lakhs
Bank overdraft	8 lakhs

(Assume all sales occur evenly throughout the year.)

You are required to :

(a) Calculate the debtors velocity (in days) from the above figures.

(b) Calculate a target debtors' velocity (in days) necessary to reduce H Ltd.'s trade debtors by ₹ 6,00,000.

(c) Calculate the estimated debtors balance and overdraft which would have been outstanding if the suggestions of the accounts officer were accepted.

Solution

(a) Debtors' Velocity (in days) = $\dfrac{\text{Trade Debtors}}{\text{Credit Sales}} \times 365$

$$= \frac{22 \text{ Lakhs}}{140 \text{ Lakhs}} \times 365 = 57 \text{ days (rounded off)}$$

(b) Target Debtors' Velocity (in days) = $\dfrac{\text{Trade Debtors} - 6 \text{ Lakhs}}{\text{Credit Sales}} \times 365$

$$= \frac{22 \text{ Lakhs} - 6 \text{ Lakhs}}{140 \text{ Lakhs}} \times 365 = 42 \text{ days (rounded off)}$$

(c) Estimated Debtors:

Trade Debtors as per financial statements		22,00,000
Less: Gross Collection from March 2012 Sales		
March Sales $\left(\dfrac{140 \text{ Lakhs}}{365} \times 31 \text{ days}\right) \times 40\%$		4,75,616
		17,24,385
Estimated Overdraft		
Existing Overdraft		8,00,000
Less: **Net collection from Debtors**		
Gross collection	4,75,616	
Less: 2% Discount on ₹ 4,75,622	9,512	4,66,104
		3,33,896

Calculation of Different Items of Profit and Loss Account and Balance Sheet

Illustration 58

The following ratio and information relate to the business of Lakhotia Traders Ltd.:

(i) Credit period allowed to Debtors — 2 months; (ii) Inventories Turnover ratio 8 times; (iii) Lag in payment to suppliers — 1 month; (iv) Gross Profit ratio 25%; (v) Opening inventories ₹ 1,05,000; and (vi) Gross Profit for the year ended 31st March, 2012 amounted to ₹ 3,00,000.

Find out : (a) Sales; (b) Sundry Debtors; (c) Closing Inventories; and (d) Sundry Creditors.

Solution

(a) Calculation of Sales

It is given that Gross Profit = 25%. It means, when Gross Profit is ₹ 25 then Sales will be ₹ 100.

So, when Gross Profit = ₹ 3,000, then Sales will be ₹ 3,00,000 × 100/25 = ₹ **12,00,000**.

(b) Calculation of Sundry Debtors

It is given that credit period allowed to Debtors = 2 months. So Sundry Debtors will be equal to two months credit sales. Therefore, Sundry Debtors = ₹ 12,00,000 / 12 × 2 = ₹ **2,00,000** (It is assumed that all Sales are Credit Sales).

(c) Calculation of Closing Inventories

$$\text{Inventories Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$\text{or, } 8 = \frac{12{,}00{,}000 - 3{,}00{,}000}{(\text{Opening Stock} + \text{Closing Stock}) / 2}$$

$$\text{or, } 8 = \frac{9{,}00{,}000}{(1{,}05{,}000 + \text{Closing Stock}) / 2}$$

or, 8 (₹ 1,05,000 + Closing Inventories) = ₹ 9,00,000 × 2

or 8 Closing Inventories = ₹ 18,00,000 – 8,40,000

or Closing Inventories = ₹ **1,20,000**.

(d) Calculation of Sundry Creditors

Purchases = Cost of Goods Sold + Closing Inventories – Opening Inventories

or Purchases = ₹ 9,00,000 + ₹ 1,20,000 – ₹ 1,05,000 = ₹ 9,15,000 (It is assumed that all purchases are credit purchases)

(e) Creditors = 1 month's purchase = ₹ 9,15,000 / 12 = ₹ **76,250**.

Illustration 59

Following are the ratios relating to the trading activities of National Traders Ltd. :

Debtors' velocity 3 months; Inventories velocity 8 months; Creditors' velocity 2 months; Gross Profit ratio 25%.

Gross Profit for the year ended 31st December, 2008 amounts to ₹ 4,00,000. Closing Inventories of the year is ₹ 10,000 above the Opening Inventories. Bills Receivable amount to ₹ 25,000 and Bills Payable amount to ₹ 10,000. Find out:

(i) Sales; (ii) Sundry Debtors; (iii) Closing Inventories; and (iv) Sundry Creditors.

[C.A. (PE-II) — May, 2002]

Solution

(i) Calculation of Sales

It is given that Gross Profit ratio = 25%. It means that when Gross Profit is ₹ 25 then Sales will be ₹ 100. Gross Profit = ₹ 4,00,000. Therefore Sales = ₹ 4,00,000 × 100/25 = ₹ **16,00,000** (It is assumed that all Sales are Credit Sales).

(ii) Calculation of Sundry Debtors

Debtors velocity = Receivables / Sales × 12

or 3 = Receivables / Sales × 12

or Receivables = ₹ (16,00,000 × 3) / 12 = ₹ 4,00,000

Receivables = Sundry Debtors + Bills Receivable

or Sundry Debtors = ₹ 4,00,000 – ₹ 25,000 = ₹ **3,75,000**.

(iii) Calculation of Closing Inventories

Cost of Goods Sold = Sales – Gross Profit

or Cost of Goods Sold = ₹ 16,00,000 – 4,00,000 = ₹ 12,00,000.

Inventories velocity = Average Inventories / Cost of Goods Sold × 12

or 8 = Average Inventories / ₹ 12,00,000 × 12

or ₹ 96,00,000 = 12 Average Inventories

or Average Inventories = ₹ 8,00,000

Let Opening Inventories = x

Average Inventories = {x + (x + ₹ 10,000)} / 2

or 2 Average Inventories = 2x + ₹ 10,000

or 2x = (2 × ₹ 8,00,000) – ₹ 10,000

or 2x = ₹ 15,90,000

or x = ₹ 7,95,000.

So, Opening Inventories = ₹ 7,95,000 and Closing Inventories = ₹ 7,95,000 + ₹ 10,000 = ₹ **8,05,000**.

(iv) Calculation of Creditors

Purchases = Cost of Goods Sold + Closing Inventories – Opening Inventories

= ₹ 12,00,000 + 8,05,000 – 7,95,000 = ₹ **12,10,000** (It is assumed that all purchases are credit purchases).

Creditors velocity = Payables / Purchases × 12

or 2 = Payables / ₹ 12,10,000 × 12

or 12 Payables = ₹ 24,20,000

or Payables = ₹ 2,01,667 (Approx.)

Payables = Sundry Creditors + Bills Payable

Sundry Creditors = ₹ 2,01,667 – 10,000 = ₹ **1,91,667**.

Illustration 60

The Directors of Bharucha Enterprises Ltd ask you to ascertain:

(a) Proprietors' Funds; (b) Fixed Assets; (c) Closing Debtors; (d) Closing Creditors; (e) Closing Inventories; (f) Share Capital; and (g) Cash and Bank Balances.

From the following information:

(i) Inventory turnover ratio is 6 times
Year end debtors are outstanding for 2 months
Year end creditors are outstanding for 73 days.

(ii) Ratios of cost of goods sold to :
(a) Proprietors' funds is 2 : 1; and (b) Fixed assets is 4 : 1.

(iii) Ratio of gross profit to sales is 20%.

(iv) Closing inventories is greater than the opening inventories by ₹ 10,000.

(v) The gross profit for the year ended 31st March, 1998 is ₹ 1,20,000.

(vi) Reserves and surplus appearing in the Balance Sheet as at 31st March, 1998 total to ₹ 40,000.

Solution

(a) Calculation of Proprietors' Funds

Ratio of cost of goods sold to proprietors' Funds is 2 : 1.

$$\text{or } \frac{\text{Cost of Goods Sold}}{\text{Proprietors' Funds}} = \frac{2}{1}$$

$$\text{Proprietors' Funds} = \frac{4{,}80{,}000 \text{ (Note 2)}}{2} = \textbf{Rs 2,40,000}$$

(b) Calculation of Fixed Assets

Ratio of cost of goods sold to fixed assets is 4 : 1.

$$\text{or } \frac{\text{Cost of Goods Sold}}{\text{Fixed Assets}} = \frac{4}{1}$$

$$\text{Fixed Assets} = \frac{4{,}80{,}000 \text{ (Note 2)}}{4} = ₹\ \textbf{1,20,000}$$

(c) Calculation of Closing Debtors

Year end Debtors are outstanding for 2 months, i.e., they represent 2/12 of annual sales of ₹ 6,00,000.

$$\text{Hence, Debtors} = \frac{6{,}00{,}000}{12} \times 2 = ₹\ \textbf{1,00,000}$$

(d) Calculation of Closing Creditors

Year end Creditors are outstanding for 73 days, i.e., they represent 1/5 of annual purchases of ₹ 4,90,000 (Note 3).

$$\text{Hence, Creditors} = \frac{4{,}90{,}000}{5} \times 1 = ₹\ \textbf{98,000}$$

(e) Calculation of Closing Inventories

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average Stock}}$$

$$\text{or } 6 = \frac{\text{Cost of goods sold}}{\text{Average Stock}}$$

or 6 Average Inventories = ₹ 4,80,000

or Average Inventories = ₹ 80,000.

Let opening inventories = x

Average inventories = {x + (x + ₹ 10,000)} / 2

or 2 Average Inventories = 2x + ₹ 10,000.

or (2 × ₹ 80,000) = 2x + ₹ 10,000

or 2x = ₹ 1,60,000 – ₹ 10,000

or x = ₹ 1,50,000 / 2 = ₹ **75,000**.

Therefore, Opening Inventories = ₹ 75,000 and Closing Inventories = ₹ 75,000 + ₹ 10,000 = ₹ **85,000**.

(f) Calculation of Share Capital

Proprietors' Funds = Share Capital + Reserve and Surplus

or Share Capital = Proprietors' Funds – Reserve and Surplus

or Share Capital = ₹ 2,40,000 (a) – ₹ 40,000 (given) = ₹ **2,00,000.**

(g) Calculation of Cash and Bank Balances

Proprietors' Funds + Creditors = Fixed Assets + Closing Inventories + Debtors + Cash and Bank Balances

₹ 2,40,000 + ₹ 98,000 (d) = ₹ 1,20,000 (b) + ₹ 85,000 (e) + ₹ 1,00,000 (c) + Cash and Bank Balances

or ₹ 3,38,000 = ₹ 3,05,000 + Cash and Bank Balances

or Cash and Bank Balances = ₹ 3,38,000 – ₹ 3,05,000 = ₹ **33,000**.

Working Notes :

(1) Calculation of Sales

It is given that Gross Profit = 20%. It means that when Gross Profit is ₹ 20 then Sales will be ₹ 100.

So when Gross Profit = ₹ 1,20,000, then Sales will be ₹ 1,20,000 × 100 / 20 = ₹ **6,00,000.**

(2) Calculation of Cost of Goods Sold

Cost of Goods Sold = Sales – Gross Profit = ₹ 6,00,000 – ₹ 1,20,000 = ₹ **4,80,000.**

(3) Calculation of Purchases

Purchases = Cost of Goods Sold + Closing Inventories – Opening Inventories = ₹ 4,80,000 (Note 2) + ₹ 10,000 (given) = ₹ **4,90,000**.

Preparation of Balance Sheet and Statement of Proprietors' Funds

Illustration 61

From the following particulars, prepare a summarised Balance Sheet in detail as at 31st March, 2016 :

Fixed Assets to Networth = 0.8 : 1.
Current Ratio — 3 : 1
Fixed Assets — ₹ 8,00,000.
Reserve included in proprietor's fund — 25%
Acid Test Ratio — 3 : 2
Cash and Bank — ₹ 15,000
Long-term Loan — ?

Solution **Balance Sheet as at 31st March, 2016**

Liabilities	₹	Assets		₹
Share Capital	7,50,000	Fixed Assets		8,00,000
Reserve	2,50,000	Current Assets :		
Current Liabilities	1,00,000	Bank	15,000	
Long-term Loan (b/f)	—	Stock	1,50,000	
		Others	1,35,000	3,00,000
	11,00,000			11,00,000

(1) $\dfrac{\text{Fixed Assets}}{\text{Networth}} = \dfrac{0.8}{1}$

$\dfrac{8,00,000}{\text{Networh}} = \dfrac{0.8}{1}$ Networth = 10,00,000.

Fixed Assets + Working Capital = 10,00,000
Working Capital = 10,00,000 – 8,00,000 = 2,00,000

(2) $\dfrac{\text{Current Aassets}}{\text{Current Liabilities}} = \dfrac{3}{1}$ or Current Assets = 3 Current Liabilities.
or, Current Assets – Current Liabilities = 2,00,000
3 Current Liabilities – Current Liabilities = 2,00,000
Current Liabilities = 2,00,000; Current Liabilities = 1,00,000; Current Assets = 3 × 1,00,000 = 3,00,000.

$\dfrac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = \dfrac{3}{2}$ or, $\dfrac{3,00,000 - \text{Stock}}{1,00,000} = \dfrac{3}{2}$

or, 6,00,000 – 2 Stock = 3,00,000
or, 2 Stock = 3,00,000
or, Stock = 1,50,000.

Illustration 62

From the following information, prepare a summarised Balance Sheet of X Ltd. as at 31st March, 2016 assuming that Capital is composed of Equity Shares of ₹ 10 each.

Liquid Ratio	1.5
Current Ratio	2.5
Asset (Fixed) Proprietorship Fund Ratio	0.75
Working Capital	₹ 1,20,000
Reserve and Surplus	₹ 60,000
Bank Loan	₹ 20,000

Solution **Balance Sheet of X Ltd. as at 31st March, 2016**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		4,20,000
(b) Reserves and Surplus		60,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		20,000
(b) Other Current Liabilities	3(b)	60,000
TOTAL		5,60,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,60,000
(2) Current Assets :		
(a) Inventories	(2)	80,000
(b) Other Current Assets	3(a)	1,20,000
TOTAL		5,60,000

Working Notes :

(1) Calculation of Current Assets and Current Liabilities

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5 : 1$$

Working Capital = Current Assets – Current Liabilities = 2.5 – 1 = 1.5.

Working Capital = 1.5 = ₹ 1,20,000 (given).

$$\text{Therefore, Current Assets} = \frac{1,20,000}{1.5} \times 2.5 = ₹\ \mathbf{2,00,000}$$

$$\text{Current Liabilities} = \frac{1,20,000}{1.5} \times 1 = ₹\ \mathbf{80,000}$$

.

(2) Calculation of Inventories

$$\text{Liquid Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}} = 1.5 : 1$$

Current Liability = ₹ 80,000.
Current Assets – Inventories = ₹ 80,000 × 1.5 = ₹ 1,20,000.
Inventories = ₹ (2,00,000 – 1,20,000) = ₹ **80,000**.

(3) Calculation of Other Current Assets and Other Current Liabilities

(a) Other Current Assets = Total Current Assets – Inventories = ₹ 2,00,000 – ₹ 80,000 = ₹ 1,20,000.
(b) Other Current Liabilities = Total Current Liabilities – Bank Loan = ₹ 80,000 – ₹ 20,000 = ₹ 60,000.

(4) Calculation of Proprietors' Funds

Fixed Assets to Proprietorship Fund = 0.75. It means 0.75 of the proprietors' fund has been invested in fixed assets and the balance 0.25 has been invested in working capital.
0.25 of Proprietors' funds = Working Capital = ₹ 1,20,000.

$$\text{Therefore, Propritoers' Funds} = \frac{1,20,000}{0.25} = ₹\ \mathbf{4,80,000}$$

(5) Calculation of Equity Share Capital

Proprietors' Funds = Share Capital + Reserve and Surplus
or ₹ 4,80,000 = Share Capital + ₹ 60,000 (given)
or Share Capital = ₹ 4,80,000 – ₹ 60,000 = ₹ 4,20,000.

(6) Calculation of Fixed Assets

Fixed Assets = 0.75 of the Proprietors' Funds = 0.75 × ₹ 4,80,000 = ₹ **3,60,000**.

Illustration 63

From the following information of Mr. S. R. Gupta, make out a Statement of Proprietors' Funds with as many details as possible:

(i)	Current Ratio	2.5
(ii)	Liquid Ratio	1.5
(iii)	Proprietory Ratio (Fixed Assets / Proprietory Funds)	0.75
(iv)	Working Capital	₹ 1,20,000
(v)	Reserve and Surplus	₹ 80,000
(vi)	Bank Overdraft	₹ 20,000
(vii)	There are no long term loans and fictitious assets.	
(viii)	Bank Overdraft is not payable immediately.	

Solution **Statement of Proprietors' Funds as on . . .**

Liabilities		₹	₹
Sources of Funds			
Share Capital (Note 5)			4,00,000
Reserves and Surplus			80,000
			4,80,000
Application of Funds			
Fixed Assets (Note 4)			3,60,000
Current Assets :			
Inventories (Note 2)	1,10,000		
Quick Assets (Note 2)	90,000	2,00,000	
Less: *Current Liabilities*			
Other Current Liabilities (Note 3)	60,000		
Bank Overdraft	20,000	80,000	1,20,000
			4,80,000

Working Notes :

(1) Calculation of Current Assets and Current Liabilities

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5 : 1$

Working Capital = Current Assets – Current Liabilities = 2.5 – 1 = 1.5.
Working Capital = 1.5 = ₹ 1,20,000 (given).

Therefore, Current Assets = $\frac{1,20,000}{1.5} \times 2.5$ = ₹ 2,00,000

Current Liabilities = $\frac{1,20,000}{1.5} \times 1$ = ₹ 80,000

(2) Calculation of Inventories

Quick Ratio = $\frac{\text{Quick Assets}}{\text{Quick Liabilities}} = 1.5 : 1$

Quick Liabilities = Current Liabilities – Overdraft = ₹ 80,000 – ₹ 20,000 = ₹ **60,000**.
Quick Assets = ₹ 60,000 × 1.5 = ₹ **90,000**.
Inventories = Current Assets – Quick Assets = ₹ 2,00,000 – ₹ 90,000 = ₹ **1,10,000**.

(3) Calculation of Other Current Liabilities

	₹
Total Current Liabilities	80,000
Less: Overdraft	20,000
	60,000

(4) Calculation of Proprietors' Funds and Fixed Assets

Fixed Assets to Proprietorship Fund = 0.75. It means 0.75 of the proprietors' fund has been invested in fixed assets and the balance 0.25 has been invested in working capital.

0.25 of Proprietors' funds = Working Capital = ₹ 1,20,000.

Therefore, Proprietors' Funds = $\frac{1,20,000}{.25}$ = ₹ 4,80,000

Fixed Assets = 0.75 of ₹ 4,80,000 = ₹ **3,60,000**.

(5) Calculation of Capital

Proprietors' Funds = Capital + Reserve and Surplus

or, Capital = Proprietors' Fund – Reserves and Surplus = ₹ 4,80,000 – ₹ 80,000 = ₹ **4,00,000**.

Illustration 64

From the following information prepare a Balance Sheet of Moon Ltd. as on 31.12.2015 :

Current Ratio		2 : 1
Liquidity Ratio		1.25 : 1
Fixed Assets to Proprietorship Ratio		0.75 : 1
Gearing Ratio (Preference Share Capital to Equity Share Capital)		5 : 1
Working Capital	₹ 8,000	
Reserves and Surplus	₹ 2,000	
Bank Loan (Not payable immediately)	₹ 2,000	
Long-term Loan	Nil	

Solution **Balance Sheet of Moon Ltd. as at 31st December, 2015**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :		
Equity Share Capital		5,000
Preference Share Capital		25,000
(b) Reserves and Surplus		2,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		2,000
(b) Other Current Liabilities	(4)	6,000
TOTAL		40,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	24,000
(2) Current Assets :		
(a) Inventories — Stock	(2)	6,000
(b) Other Current Assets	(3)	10,000
TOTAL		40,000

Working Notes :

(1) Calculation of Current Assets and Current Liabilities

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ = 2 : 1

Working Capital = Current Assets – Current Liabilities = 2 – 1 = 1.

Working Capital = ₹ 8,000.

Therefore, Current Assets = $\frac{8,000}{1} \times 2$ = ₹ **16,000**

Current Liabilities = $\frac{8,000}{1} \times 1$ = ₹ **8,000**

(2) Calculation of Inventories / Stock

Liquid Ratio = $\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$

= 1.25 × Current Liabilities = Current Assets
or, 1.25 × ₹ 8,000 = Current Assets – Stock
or Stock = Current Assets – ₹ 10,000
or Stock = ₹ 16,000 – ₹ 10,000
or, Stock = ₹ 6,000

(3) Calculation of Other Current Assets = Total Current Assets – Inventories = ₹ 16,000 – ₹ 6,000 = ₹ **10,000**.

(4) Calculation of Other Current Liabilities = Total Current Liabilities – Bank Loan = ₹ 8,000 – ₹ 2,000 = ₹ **6,000**.

(5) Calculation of Proprietors' Funds and Fixed Assets

Fixed Assets to Proprietorship Fund = 0.75. It means 0.75 of the proprietors' fund has been invested in fixed assets and the balance 0.25 has been invested in working capital.

0.25 of Proprietors' funds = Working Capital = ₹ 8,000.

Therefore, Propritoers' Funds = $\frac{8,000}{0.25}$ = ₹ **32,000**

Fixed Assets = .75 of ₹ 32,000 = ₹ **24,000**.

(6) Calculation of Share Capital

Proprietors' Funds = Share Capital + Reserve and Surplus
or, ₹ 32,000 = Share Capital + ₹ 2,000 (Given)
or, Share Capital = ₹ 32,000 – ₹ 2,000 = ₹ **30,000**.

(a) Preference Share Capital = $\frac{30,000}{6} \times 5$ = ₹ **25,000**

(b) Equity Share Capital = $\frac{30,000}{6} \times 1$ = ₹ **5,000**

Illustration 65

From the following particulars prepare a summarised Balance Sheet of a sole proprietor in detail as at 31st December, 2015 :

Fixed Assets to Networth	0.8 : 1
Current Ratio	3 : 1
Reserve included in Proprietors' Fund	25%
Acid Test Ratio	3 : 2
Fixed Assets	₹ 8,00,000
Cash and Bank Balance	₹ 15,000
Current Liabilities	₹ 1,50,000
Long-term Loan	?

Solution **Balance Sheet as at 31st December, 2015**

Liabilities	₹	Assets	₹
Equity Share Capital (Note 2)	7,50,000	Fixed Assets	8,00,000
Reserve (Note 2)	2,50,000	Inventories (Note 2)	2,25,000
Long-term Loan (Balancing figure)	1,00,000	Other Current Assets (Note 5)	2,10,000
Current Liabilities	1,50,000	Cash and Bank Balances	15,000
	12,50,000		12,50,000

Working Notes :

(1) Calculation of Net Worth

Fixed Assets to Networth = 0.8 : 1. It means when fixed asset is 0.8 then networth will be 1. Fixed Assets ₹ 8,00,000 (Given).

Therefore, Networth = $\frac{8,00,000}{0.8}$ = ₹ 10,00,000

(2) Calculation of Reserve and Capital

Reserve = 25% of Proprietors' Fund / Networth

= 25% of ₹ 10,00,000 = ₹ **2,50,000**.

Networth = Share Capital + Reserve

or Share Capital = Networth – Reserve

or Share Capital = ₹ 10,00,000 – 2,50,000 = ₹ 7,50,000.

Tutorial Note : Networth and Proprietors' Fund have been used synonymously.

(3) Calculation of Current Assets

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 3 : 1$$

Current Liabilities = ₹ 1,50,000 (given)

Therefore, Current Assets = ₹ 1,50,000 × 3 = ₹ **4,50,000**.

(4) Calculation of Inventories

$$\text{Acid Test Ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}} = 3 : 2$$

2 (Current Assets – Inventories) = 3 (Current Liabilities)

or 2 Inventories = ₹ 9,00,000 – ₹ 4,50,000

or Inventories = ₹ 4,50,000 / 2 = ₹ **2,25,000**.

(5) Calculation of Other Current Assets

Total Current Assets = Inventories + Cash and Bank + Other Current Assets

or ₹ 4,50,000 = ₹ 2,25,000 + ₹ 15,000 + Other Current Assets

or Other Current Assets = ₹ **2,10,000**.

Illustration 66

From the following information relating to Moon Light Ltd., prepare a Balance Sheet as on 31st March, 2016 :

(i)	Current Ratio	2.5
(ii)	Liquid Ratio	1.5
(iii)	Net Working Capital	₹ 3,00,000
(iv)	Cost of Sales / Closing Inventories	8 times
(v)	G.P. Ratio	20%
(vi)	Average Debt Collection Period	1.5 months
(vii)	Fixed Assets / Shareholders' Networth	0.75
(viii)	Reserves and Surplus / Share Capital	0.50

Solution **Balance Sheet of Moon Light Ltd. as at 31st March, 2016**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :		8,00,000
(b) Reserves and Surplus		4,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Other Current Liabilities	(1)	2,00,000
TOTAL		14,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(5)	9,00,000
(2) Current Assets :		
(a) Inventories — Stock	(2)	2,00,000
(b) Trade Receivables — Debtors	(3)	2,50,000
(b) Other Current Assets		50,000
TOTAL		14,00,000

Working Notes :

(1) Calculation of Current Assets and Current Liabilities

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5 : 1$$

Net Working Capital = Current Assets – Current Liabilities = 2.5 – 1 = 1.5.

Net Working Capital = ₹ 3,00,000.

$$\text{Therefore, Current Assets} = \frac{3,00,000}{1.5} \times 2.5 = ₹\ \mathbf{5,00,000}$$

$$\text{Current Liabilities} = \frac{3,00,000}{1.5} \times 1 = ₹\ \mathbf{2,00,000}$$

(2) Calculation of Inventories

$$\text{Liquid Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = 1.5 : 1$$

Quick Liabilities = Current Liabilities = ₹ **2,00,000**.

$$\text{Quick Assets} = \frac{2,00,000}{1} \times 1.5 = ₹\ 3,00,000$$

Quick Assets = Current Assets – Inventories

or ₹ 3,00,000 = 5,00,000 – Inventories

or Inventories = ₹ **2,00,000**.

(3) Calculation of Debtors

Cost of Sales / Closing Inventories = 8 times.

Therefore, Cost of Sales = ₹ 2,00,000 × 8 = ₹ 16,00,000.

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = 20\%$$

If the sales is ₹ 100, then gross profit is 20 and cost of sales = ₹ 100 – 20 = ₹ 80.

When cost of sales is ₹ 80 then sales = ₹ 100

When cost of sales is Re 1 then sales = ₹ 100 / ₹ 80

When cost of sales is ₹ 16,00,000 then sales = ₹ 100 / ₹ 80 × ₹ 16,00,000 = ₹ 20,00,000.

$$\text{Debtors} = \frac{20,00,000}{12} \times 1.5 = ₹\ \mathbf{2,50,000}.$$

(4) Calculation of Shareholders' Networth

Fixed Assets / Shareholders' Networth = 0.75

It means 0.75 of the shareholders' networth has been invested in fixed assets and balance 0.25 has been invested in Working Capital.

0.25 of the shareholders' networth $= \frac{3,00,000}{0.25}$. Therefore, total shareholders' networth = ₹ **12,00,000**.

(5) Calculation of Fixed Assets

Fixed Assets = ₹ 12,00,000 × 0.75 = ₹ **9,00,000**.

(6) Calculation of Share Capital and Reserve and Surplus

Reserve and Surplus / Share Capital = 0.5 : 1.

$$\text{Therefore, Reserve and Surplus} = \frac{12,00,000}{1.5} \times .5 = ₹\ \mathbf{4,00,000}$$

$$\text{Share Capital} = \frac{12,00,000}{1.5} \times 1 = ₹\ \mathbf{8,00,000}$$

(7) Other Current Assets

Total Current Assets = Inventories + Debtors + Other Current Assets

Other Current Assets = ₹ 5,00,000 – ₹ 2,00,000 – ₹ 2,50,000 = ₹ **50,000**.

Illustration 67

From the following information, prepare a summarised Balance Sheet of Amar, a sole proprietor as at 31st March, 2016 :

Inventories velocity	6
Fixed assets to turnover ratio	4
Capital turnover ratio	2
Gross Profit	20%
Debt collection period	2 months
Creditors payment period	73 days

The gross profit was ₹ 60,000.
Closing inventories was ₹ 5,000 in excess of opening inventories. All workings should form part of your answer.

Solution

Amar
Balance Sheet as at 31st March, 2016

Liabilities	₹	Assets	₹
Capital (Note 7)	1,50,000	Fixed Assets (Note 4)	75,000
Sundry Creditors (Note 6)	49,000	Inventories (Note 3)	42,500
		Sundry Debtors (Note 5)	50,000
		Cash and Bank	31,500
	1,99,000		1,99,000

Working Notes :

(1) Calculation of Sales

Gross Profit Ratio $= \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = 20\%$

When G.P. is ₹ 20 then Sales will be ₹ 100
When G.P. is Re 1 then Sales will ₹ 100 / 20

When G.P. is ₹ 60,000 then Sales will be $\frac{100 \times 60{,}000}{20}$ = **₹ 3,00,000**

(2) Calculation of Cost of Goods Sold

Cost of Goods Sold = Sales – Gross Profit = ₹ 3,00,000 – ₹ 60,000 = ₹ **2,40,000**.

(3) Calculation of Average Inventories, Opening Inventories and Closing Inventories

Inventories velocity $= \frac{\text{Cost of goods sold}}{\text{Average Stock}} = 6$

or 6 Average Inventories = Cost of Goods Sold

or Average Inventories $= \frac{2{,}40{,}000}{6}$ = ₹ **40,000**

Let opening inventories = x
Average inventories = {x + (x + ₹ 5,000)} / 2
or 2 Average Inventories = 2x + ₹ 5,000.
or 2x = (2 × ₹ 40,000) – ₹ 5,000
or 2x = ₹ 75,000
or x = ₹ **37,500**.
x = Opening Inventories = ₹ 37,500.
Closing Inventories = ₹ 37,500 + ₹ 5,000 = ₹ **42,500**.

(4) Calculation of Fixed Assets

Fixed Assets to Turnover Ratio $= \frac{\text{Turnover}}{\text{Fixed Assets}}$

or 4 Fixed Assets = Turnover

or Fixed Assets $= \frac{3{,}00{,}000 \text{ (Note 1)}}{4}$ = ₹ **75,000**.

(5) Calculation of Sundry Debtors

Debt collection period = 2 months

Sundry Debtors $= \frac{3{,}00{,}000}{12} \times 2$ = ₹ **50,000**.

(6) Calculation of Creditors

Purchases = Cost of goods sold + Closing Inventories – Opening Inventories = ₹ 2,40,000 + ₹ 42,500 – ₹ 37,500 = ₹ **2,45,000.**

Sundry Creditors $= \frac{\text{Rs } 2{,}45{,}000}{365} \times 73 = \text{Rs } 49{,}000$ (It has been assumed that all purchases are on credit.)

(7) Calculation of Capital

Capital Turnover Ratio $= \frac{\text{Turnover}}{\text{Capital}}$

or 2 Capital = Turnover

or Capital $= \frac{3{,}00{,}000}{2}$ = ₹ **1,50,000**

Illustration 68

Using the following data, complete the Balance Sheet of X Limited as at 31.3.2000 :

(a) Gross Profit 25% of Sales
(b) Gross Profit = ₹ 1,20,000
(c) Shareholders' equity = ₹ 20,000
(d) Credit sales to total sales = 80%
(e) Total turnover to total assets = 4 times
(f) Cost of sales to Inventory = 10 times
(g) Average collection period = 5 days, assume 365 days in a year.
(h) Long-term debt = ?
(i) Current ratio = 1.5
(j) Sundry Creditors = ₹ 60,000.

Balance Sheet of X Limited as at 31.3.2000

Liabilities	₹	Assets	₹
Sundry Creditors		Cash	
Long-term Debt (Balancing figure)		Sundry Debtors	
Share Capital		Inventory	
		Fixed Assets	

[C.A. (Inter) — November, 2000]

Solution

X Limited
Balance Sheet as at 31st March, 2000

Liabilities	₹	Assets	₹
Sundry Creditors	60,000	Cash (Note 7)	48,740
Long-term Debt (Balancing figure)	40,000	Sundry Debtors (Note 6)	5,260
Share Capital	20,000	Inventory (Note 3)	36,000
		Fixed Assets	30,000
	1,20,000		1,20,000

Working Notes :

(1) Calculation of Sales

It is given that gross profit = 25% of sales. It means when gross profit is ₹ 25, then sales will be ₹ 100. So when gross profit = ₹ 1,20,000 then, sales will be ₹ 1,20,000 × 100 / 25 = ₹ **4,80,000**.

(a) Credit Sales = 80% of ₹ 4,80,000 = ₹ 3,84,000
(b) Cash Sales = 20% of ₹ 4,80,000 = ₹ 96,000.

(2) Calculation of Cost of Goods Sold

Cost of Goods Sold = Sales – Gross Profit = ₹ 4,80,000 – ₹ 1,20,000 = ₹ **3,60,000**.

(3) Calculation of Closing Inventory

Cost of Sales to Inventory = 10 times.

$$\frac{\text{Cost of Sales}}{\text{Inventory}} = \frac{10}{1}$$

Inventory = ₹ 3,60,000 / 10 = ₹ 36,000.

(It is assumed that cost of sales does not include any selling expenses or wages or overhead.)

(4) Calculation of Total Assets

Total Turnover to Total Assets = 4 times.

$$\frac{\text{Total Turnover}}{\text{Total Assets}} = \frac{4}{1} \quad \text{Total Assets} = \frac{4{,}80{,}000 \text{ (Note 1)}}{4} = ₹\ 1{,}20{,}000$$

(5) Calculation of Current Assets

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 1.5 : 1$$

1.5 Current Liabilities = Current Assets

or Current Assets = ₹ 60,000 × 1.5 = ₹ **90,000**.

(6) Calculation of Debtors

Average collection period = 5 days

$$\text{Debtors} = \frac{\text{Credit Sales}}{365} \times 5$$

Debtors = $\frac{3,84,000 \ (1a)}{365} \times 5$ = ₹ **5,620 (approx)**.

(7) Calculation of Cash

Current Assets = ₹ 90,000

Cash + Debtors + Inventory = ₹ 90,000

Cash = ₹ 90,000 – ₹ 5,260 – ₹ 36,000 = ₹ **48,740**.

Illustration 69

From the following information relating to Wise Limited, you are required to prepare its summarised Balance Sheet :

(a) Current Ratio	2.5	(g) Sales / Debtors Ratio	6.0
(b) Acid Test Ratio	1.5	(h) Reserves / Capital Ratio	1.0
(c) Gross Profit / Sales Ratio	0.2	(i) Networth / Long-term Loan Ratio	20.0
(d) Net Working Capital / Net Worth Ratio	0.3	(j) Inventories velocity	2 Months
(e) Sales / Net Fixed Assets Ratio	2.0	(k) Paid-up Share Capital	₹ 10 Lakhs
(f) Sales / Networth Ratio	1.5		

Solution **Balance Sheet of Wise Limited as at 31st March, 2016**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :		10,00,000
(b) Reserves and Surplus	(1)	10,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings	(11)	1,00,000
(4) Current Liabilities :		
(a) Long-term Borrowings	(4)	4,00,000
TOTAL		25,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(9)	15,00,000
(2) Current Assets :		
(a) Inventories — Stock	(8)	4,00,000
(b) Trade Receivables — Debtors	(10)	5,00,000
(b) Other Current Assets		1,00,000
TOTAL		25,00,000

Working Notes :

(1) Calculation of Reserve

Reserve / Capital Ratio = 1. Paid-up Share Capital = ₹ 10,00,000. Therefore, Reserves = ₹ **10,00,000**.

(2) Calculation of Networth

Networth = Share Capital + Reserves = ₹ 10,00,000 + ₹ 10,00,000 = ₹ **20,00,000**.

(3) Calculation of Net Working Capital

Net Working Capital / Networth = 0.3. Networth = ₹ 20,00,000. Therefore, Net Working Capital = ₹ 20,00,000 × .3 = ₹ **6,00,000**.

(4) Calculation of Current Assets and Current Liabilities

Current Assets – Current Liabilities = Net Working Capital = 2.5 – 1 = 1.5 = ₹ 6,00,000.

Therefore, Current Assets = (₹ 6,00,000 / 1.5) × 2.5 = ₹ **10,00,000**. Current Liabilities = (₹ 6,00,000 / 1.5) × 1 = ₹ **4,00,000**.

(5) Calculation of Sales

Sales / Networth Ratio = 1.5. Therefore, Sales = ₹ 20,00,000 × 1.5 = ₹ **30,00,000**.

(6) Calculation of Gross Profit

Gross Profit / Sales Ratio = .2. Therefore, Gross Profit = ₹ 30,00,000 × 0.2 = ₹ **6,00,000**.

(7) Calculation of Cost of Goods Sold

Cost of Goods Sold = Sales – Gross Profit = ₹ 30,00,000 – ₹ 6,00,000 = ₹ **24,00,000**.

(8) Calculation of Inventories

$$\text{Acid Test Ratio} = \frac{\text{Quick Assets}}{\text{Quick Liabilities}} = 1.5$$

Quick Liabilities = Current Liabilities = ₹ 4,00,000.
Therefore, Quick Assets = ₹ 4,00,000 × 1.5 = ₹ 6,00,000.
Inventories = Current Assets – Quick Assets = ₹ 10,00,000 – ₹ 6,00,000 = ₹ **4,00,000**.

(9) Calculation of Fixed Assets
Sales / Fixed Assets Ratio = 2. Therefore, Fixed Assets = ₹ 30,00,000 / 2 = ₹ **15,00,000**.

(10) Calculation of Debtors
Sales / Debtors = 6. Therefore, Debtors = ₹ 30,00,000 / 6 = ₹ **5,00,000**.

(11) Calculation of Long-term Loans
Networth / Long-term Loans = 20. Therefore, Long-term Loans = ₹ 20,00,000 / 20 = ₹ **1,00,000**.

Illustration 70

From the following particulars prepare the Balance Sheet of Robin Hood Ltd. as at 31st March, 2016 :

Current Ratio	2
Working Capital	₹ 4,00,000
Capital Employed to Current Assets	3 : 2
Fixed Assets to Turnover	1 : 3
Sales Cash / Credit	1 : 2
Creditors velocity	2 months
Inventories velocity	2 months
Debtors' velocity	3 months
Capital Employed :	
Net profit 10% of Turnover	
General Reserve $2^1/_2$% of Turnover	
Debenture / Share Capital	1 : 2
Gross Profit Ratio — 25% (to Sales)	

Solution **Balance Sheet of Robin Hood Ltd. as at 31st March, 2016**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :	(6b)	6,00,000
(b) Reserves and Surplus — General Reserve	(5)	60,000
Profit and Loss Account	(5)	2,40,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Debentures	(6a)	3,00,000
(4) Current Liabilities :		
(a) Trade Payables — Trade Creditors	(8)	3,00,000
(b) Other Current Liabilities	(9)	1,00,000
TOTAL		16,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets	(3)	8,00,000
(2) Current Assets :		
(a) Inventories — Stock-in-trade	(10)	3,00,000
(b) Trade Receivables — Sundry Debtors	(7)	4,00,000
(b) Other Current Assets	(11)	1,00,000
TOTAL		16,00,000

Working Notes :

(1) Calculation of Current Assets and Current Liabilities

Current Ratio = $\dfrac{\text{Current Assets}}{\text{Current Liabilities}} = 2:1$ Working Capital =2 – 1 = 1 = ₹ 4,00,000.

Current Assets = $\dfrac{4,00,000}{1} \times 2$ = ₹ **8,00,000**

Current Liabilities = $\dfrac{4,00,000}{1} \times 1$ = ₹ **4,00,000**

(2) Calculation of Capital Employed

Capital Employed to Current Assets = 3 : 2

Capital Employed = $\dfrac{8,00,000}{2} \times 3$ = ₹ **12,00,000**

(3) Calculation of Fixed Assets

Capital Employed = Fixed Assets + Current Assets – Current Liabilities

or Fixed Assets = Capital Employed – Current Assets + Current Liabilities

= ₹ 12,00,000 – ₹ 8,00,000 + ₹ 4,00,000 = ₹ **8,00,000**.

(4) Calculation of Turnover

Fixed Assets to Turnover = 1 : 3

Turnover = $\dfrac{8,00,000}{1} \times 3$ = ₹ 24,00,000

(5) Calculation of Net profit, General Reserve

(a) Net Profit = 10% of ₹ 24,00,000 = ₹ 2,40,000

(b) General Reserve = 2.5% of ₹ 24,00,000 = ₹ 60,000.

(6) Calculation of Debentures and Share Capital

Capital Employed = Share Capital + Profit + Reserve + Debentures

or Share Capital + Debenture = ₹ 12,00,000 – ₹ 2,40,000 – ₹ 60,000 = ₹ 9,00,000.

Debenture / Share Capital = 1 : 2.

(a) Debenture = $\dfrac{9,00,000}{3} \times 1$ = ₹ **3,00,000**

(b) Share Capital = $\dfrac{9,00,000}{3} \times 2$ = ₹ **6,00,000**

(7) Calculation of Sundry Debtors

Total Sales = ₹ 24,00,000.

(a) Cash Sales = 1/3 of ₹ 24,00,000 = ₹ 8,00,000

(b) Credit Sales = 2/3 of ₹ 24,00,000 = ₹ 16,00,000

Sundry Debtors = $\dfrac{16,00,000}{12} \times 3$ = ₹ **4,00,000**

(8) Calculation of Sundry Creditors

Cost of Goods Sold = Sales – Gross Profit

Gross Profit is 25% of Sales. Therefore,

Cost of Goods Sold = ₹ 24,00,000 × 75% = ₹ 18,00,000.

Purchases = Cost of Goods Sold (because there is no change in the inventories) = ₹ 18,00,000.

Sundry Creditors = $\dfrac{18,00,000}{12} \times 2$ = ₹ **3,00,000**

(9) Calculation of Other Current Liabilities

Total Current Liabilities	4,00,000
Less: Sundry Creditors	3,00,000
Other Current Liabilities	1,00,000

(10) Calculation of Closing Inventories

Inventories velocity = Average Inventories / Cost of Goods Sold × 12

or 2 = Average Inventories / ₹ 18,00,000 × 12

or 12 Average Inventories = ₹ 36,00,000

or Average Inventories = ₹ **3,00,000**.

Assuming that opening inventories and closing inventories are same. Therefore, Average Inventories will be the closing inventories.

So, closing inventories = ₹ **3,00,000**.

(11) Calculation of Other Current Assets

Total Current Assets		8,00,000
Less: Inventories	3,00,000	
Less: Sundry Debtors	4,00,000	7,00,000
		1,00,000

Preparation of Trading, Profit and Loss Account and Balance Sheet

Illustration 71

With the help of the information given below, prepare a Trading Account, Profit and Loss Account and Balance Sheet of Amar :

(a) Gross Profit Ratio	25%	(e) Current Ratio	1
(b) Net Profit Ratio	20%	(f) Fixed Assets / Capital	5 / 4
(c) Sales / Inventory Ratio	10	(g) Fixed Assets	₹ 10,00,000
(d) Fixed Assets / Total Current Assets	5 / 7	(h) Closing Inventories	₹ 1,00,000

Solution

Amar

Dr. Trading, Profit and Loss Account for the year ended . . . Cr.

Particulars	₹	Particulars	₹
To Cost of Goods Sold (Balancing figure)	7,50,000	By Sales (Note 1)	10,00,000
To Gross Profit c/d	2,50,000		
	10,00,000		10,00,000
To Operating Expenses (Balancing figure)	50,000	By Gross Profit b/d	2,50,000
To Net Profit c/d (Note 2)	2,00,000		
	2,50,000		2,50,000

Balance Sheet of Amar as at . . .

Liabilities	₹	Assets	₹
Capital (Note 6)	8,00,000	Fixed Assets	10,00,000
Profit and Loss A/c (Note 2)	2,00,000	Closing Inventories	1,00,000
Current Liabilities (Note 5)	14,00,000	Quick Assets (Note 4)	13,00,000
	24,00,000		24,00,000

Working Notes :

(1) Calculation of Sales

$$\frac{\text{Sales}}{\text{Inventory}} = 10$$

Closing Inventories = ₹ 1,00,000 (given) $\therefore$ Sales = 10 × ₹ 1,00,000 = ₹ 10,00,000.

(2) Calculation of Gross Profit and Net Profit

(a) Gross Profit = 25% of Sales = 25% of ₹ 10,00,000 = ₹ 2,50,000.

(b) Net Profit = 20% of Sales = 20% of ₹ 10,00,000 = ₹ 2,00,000.

(3) Calculation of Total Current Assets

$$\frac{\text{Fixed Assets}}{\text{Total current Assets}} = 5 : 7$$

Fixed Assets = ₹ 10,00,000 (given).

Total Current Assets = $\frac{10,00,000}{5} \times 7$ = ₹ **14,00,000**

(4) Calculation of Quick Assets

Quick Assets = Current Assets – Inventories = ₹ 14,00,000 – 1,00,000 = ₹ **13,00,000**.

(5) Calculation of Current Liabilities

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = 1 : 1$. Total Current Assets = ₹ 14,00,000. So Current Liabilities = ₹ **14,00,000**.

(6) Calculation of Capital

$$\frac{\text{Fixed Assets}}{\text{Capital}} = 5 : 4$$

Fixed Assets = ₹ 10,00,000 (given)

$\therefore$ Share Capital = $\frac{10,00,000}{5} \times 4$ = ₹ **8,00,000**

Illustration 72

Prepare Trading Account and Balance Sheet from the following particulars :

Inventories velocity	6	Creditors Payment period	2 months
Gross Profit margin	20%	Gross Profit	₹ 60,00,000
Capital Turnover Ratio	4	Excess of Closing Inventories over Opening Inventories	₹ 5,00,000
Debt Collection Period	3 months		

Assume that no cash purchases and cash sales are made. Bank balance is the balancing figure in the Balance Sheet.

[Delhi University B.Com (Hons.) — Adapted]

Solution

Dr. Trading Account for the year ended . . . Cr.

Particulars	₹	Particulars	₹
To Opening Inventories (Note 3)	37,50,000	By Sales (Note 1)	3,00,00,000
To Purchases (Note 5)	2,45,00,000	By Closing Inventories (Note 3)	42,50,000
To Gross Profit (given)	60,00,000		
	3,42,50,000		3,42,50,000

Balance Sheet as at . . .

Liabilities	₹	Assets	₹
Capital (Note 6)	75,00,000	Inventories (Note 3)	42,50,000
Creditors (Note 5)	40,83,333	Debtors (Note 4)	75,00,000
Bank Overdraft (Balancing figure)	1,66,667		
	1,17,50,000		1,17,50,000

Working Notes :

(1) Calculation of Sales

$$\text{Gross Profit Ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 = 20\%$$

Gross Profit = ₹ 60,00,000 (given)

$$\text{Sales} = \frac{60,00,000}{20} \times 100 = ₹\ 3,00,000$$

(2) Calculation of Cost of Goods Sold

Cost of Goods Sold = Sales – Gross Profit = ₹ 3,00,00,000 – ₹ 60,00,000 = ₹ 2,40,00,000.

(3) Calculation of Opening Inventories and Closing Inventories

$$\text{Inventories Velocity} = \frac{\text{Cost of Goods sold}}{\text{Average Stock}}$$

$$\text{Average Inventories} = \frac{\text{Cost of Goods sold}}{\text{Stock Velocity}}$$

$$\text{Average Inventories} = \frac{2,40,00,000}{6} = ₹\ 40,00,000$$

$$\text{Average Inventories} = \frac{\text{Opening Stock + Closing Stock}}{2}$$

Let Opening Inventories = x

Closing Inventories = x + ₹ 5,00,000

2 Average Inventories = x + (x + ₹ 5,00,000)

or (2 × ₹ 40,00,000) = 2x + ₹ 5,00,000

or 2x = ₹ 80,00,000 – ₹ 5,00,000

$$\text{or } x = \frac{75,00,000}{2} = ₹\ 37,50,000$$

Therefore, Opening Inventories = ₹ 37,50,000 and Closing Inventories = ₹ 37,50,000 + ₹ 5,00,000 = ₹ **42,50,000**.

(4) Calculation of Debtors

Debt collection period is 3 months.

Debtors = $\frac{\text{Sales}}{12}$ × Collection Period in Month ; Debtors = $\frac{3,00,00,000 \text{ (Note 1)}}{12}$ × 3 = ₹ **75,00,000**

(5) Calculation of Purchases and Creditors

Cost of Goods Sold = Opening Inventories + Purchases – Closing Inventories

or Purchases = Cost of Goods Sold – Opening Inventories + Closing Inventories

= ₹ 2,40,00,000 – ₹ 37,50,000 + ₹ 42,50,000 = ₹ 2,45,00,000.

Creditors payment period is 2 months.

Creditors = $\frac{\text{Purchases}}{12}$ × Creditors Payment Period in Month ; Creditors = $\frac{2,45,00,000}{12}$ × 2= ₹ **40,83,333**

(6) Calculation of Capital

Capital Turnover Ratio = $\frac{\text{Sales}}{\text{Capital}}$

or 4 Capital = ₹ 3,00,00,000.

or Capital = $\frac{3,00,00,000}{4}$ = ₹ **75,00,000**

Illustration 73

Prepare Balance Sheet and Profit and Loss Account of Rohit from the following information :

Capital — ₹ 4,00,000; Working Capital — ₹ 1,80,000; Bank Overdraft (not payable immediately) — ₹ 30,000.

There is no fictitious asset. In current assets there is no assets other than inventories, debtors and cash.

Closing inventories is 20% higher than opening inventories.

Current Ratio — 2.5; Quick Ratio — 2; Proprietory Ratio (fixed assets : proprietory fund) — 0.6; Gross profit ratio — 20% (to Sales); Inventories Turnover — 5 Times; Debtors' velocity — 73 days; Net profit — 10% of capital.

Solution **Balance Sheet of Rohit as at . . .**

Liabilities	₹	Assets	₹
Capital	4,00,000	**Fixed Assets**	2,70,000
Reserve and Surplus		**Current Assets**	
General Reserve	10,000	Inventories	1,20,000
Profit and Loss	40,000	Sundry Debtors	1,37,500
Current Liabilities		Cash at Bank	42,500
Bank Overdraft	30,000		
Other Current Liabilities	90,000		
	5,70,000		5,70,000

Dr. **Trading, Profit and Loss Account of Rohit for the year ended . . .** **Cr.**

Particulars	₹	Particulars	₹
To Opening Inventories (Note 3a)	1,00,000	By Sales	6,87,500
To Purchases	5,70,000	By Closing Inventories	1,20,000
To Gross Profit c/d	1,37,500		
	8,07,500		8,07,500
To Operating Expenses	97,500	By Gross Profit b/d	1,37,500
To Net Profit	40,000		
	1,37,500		1,37,500

Working Notes :

(1) Calculation of Current Assets and Current Liabilities

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ = 2.5 : 1

Working Capital = Current Assets – Current Liabilities = 2.5 – 1 = 1.5 = ₹ 1,80,000.

(a) Current Assets = $\frac{1,80,000}{1.5}$ × 2.5 = ₹ **3,00,000** (b) Current Liabilities = $\frac{1,80,000}{1.5}$ × 1 = ₹ **1,20,000**

(2) Calculation of Quick Assets and Quick Liabilities and Inventories

Quick Ratio = $\frac{\text{Quick Assets}}{\text{Quick Liabilities}}$ = 2 : 1

(a) Quick Liabilities = Current Liabilities – Bank Overdraft
= ₹ 1,20,000 – ₹ 30,000 (given) = ₹ **90,000**.

(b) Quick Assets = ₹ 90,000 × 2 = ₹ **1,80,000**.

(c) Inventories = Current Assets – Quick Assets
= ₹ 3,00,000 – ₹ 1,80,000 = ₹ **1,20,000**.

(3) Calculation of Opening Inventories and Average Inventories

Closign Inventories = ₹ 1,20,000 (Note 2)
Closing Inventories is 20% higher than Opening Inventories
Let Opening Inventories = x
Closing Inventories = x + 20% of x = 1.2x

(a) Opening Inventories = $\frac{1,20,000}{1.2}$ = ₹ **1,00,000**

(b) Average Inventories = $\frac{\text{Opening Stock + Closing Stock}}{2} = \frac{1,00,000 + 1,20,000}{2}$ = ₹ **1,10,1000**

(4) Calculation of Cost of Goods Sold

Inventories Turnover = $\frac{\text{Cost of Goods sold}}{\text{Average Stock}}$

5 Average Inventories = Cost of Goods Sold
or Cost of Goods Sold = 5 × ₹ 1,10,000 = ₹ **5,50,000**.

(5) Cost of Sales, Debtors and Cash

Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100 = 20\%$

Let sales	100
Less: Gross Profit (20%)	20
Cost of Goods sold	80

When cost of goods sold is 80 then sales is 100
When cost of goods sold is Re 1 then sales = 100 / 80

When cost of goods sold is ₹ 5,50,000 then sales = $\frac{100 \times 5,50,000}{80}$ = ₹ **6,87,500**

Debtors velocity = 73 days

(6) (a) Debtors = $\frac{\text{Sales}}{365} \times 73 = \frac{6,87,500}{365} \times 73$ = ₹ **1,37,500**

(b) Current Assets = Inventories + Debtors + Cash
Cash = Current Assets – Inventories – Debtors = ₹ 3,00,000 – 1,20,000 – 1,37,500 = ₹ **42,500**.

(7) Calculation of Purchases

Cost of goods sold = Opening inventories + Purchases – Closing inventories
Purchases = Cost of goods sold – Opening inventories + Closing inventories
= ₹ 5,50,000 – ₹ 1,10,000 + ₹ 1,20,000 = ₹ **5,60,000**.

(8) Calculation of Proprietory Fund, Fixed Assets

$\frac{\text{Fixed Assets}}{\text{Proprietary Fund}}$ = 0.6. It means 0.6 of Proprietory Fund has been invested in Fixed Assets and balance 0.40 has been invested in Working Capital. Working Capital = ₹ 1,80,000 (given)

(a) Proprietory Fund = $\frac{1,80,000}{0.40}$ = ₹ **4,50,000**

(b) Fixed Assets = ₹ 4,50,000 × .60 = ₹ **2,70,000**.

(9) Calculation of Reserve and Surplus

Proprietory Funds = Share Capital + Reserve and Surplus
Reserve and Surplus = Proprietory Fund – Share Capital =₹ 4,50,000 – ₹ 4,00,000 = ₹ **50,000**.

Illustration 74

You have been asked by the Management of The Wonderful Suppliers Ltd to project the Balance Sheet and a Statement of Profit and Loss on the basis of the following estimated figures and ratios, for the next financial year ending March 31, 2016 :

Ratio of Gross Profit	25%
Inventories Turnover Ratio	5 Times
Average Debt Collection Period	3 months
Creditors' velocity	3 months
Current Ratio	2
Proprietory Ratio (fixed assets to capital employed)	80%
Capital Gearing Ratio (Preference Shraes and Debenture to Equity Funds)	3 : 7
Net Profit to Issued Capital (Equity)	10%
General Reserve and Profit and Loss to Issued Capital (Equity)	1 : 4
Preference Share Capital to Debentures	2
Cost of goods sold consists of 50% for materials and 50% for wages	
Gross Profit	₹ 12,50,000

Working notes should be clearly shown.

Solution **Balance Sheet of Wonderful Suppliers Ltd. as at 31st March, 2016**

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :		
Equity Share Capital (Note 12b)		28,00,000
Preference Share Capital (Note 11)		10,00,000
(b) Reserves and Surplus — General Reserve (Note 12d)		4,20,000
Profit and Loss Account (Note 12c)		2,80,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Debentures		5,00,000
(4) Current Liabilities :		
(a) Trade Payables — Trade Creditors (Note 7)		4,68,750
(b) Other Current Liabilities		5,31,250
TOTAL		60,00,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets (Note 9)		40,00,000
(2) Current Assets :		
(a) Inventories (Note 4a)		7,50,000
(b) Trade Receivables — Sundry Debtors (Note 4b)		12,50,000
TOTAL		60,00,000

Projected Statement of Profit and Loss of Wonderful Suppliers Ltd.
for the year ended 31st March, 2016

	Particulars	Note No.	Amount (₹)
	(1)	(2)	(3)
I.	Sales / Revenue from Operations	(1)	50,00,000
II.	Other Income		Nil
III.	**Total Revenue (I + II)**		50,00,000

IV.	**Expenses :**		
	Cost of materials consumed	3(a)	18,75,000
	Employee Benefits Expenses	3(b)	18,75,000
	Other Expenses (including Debenture interest)		9,70,000
V.	**Total Expenses**		47,20,000
VI.	Profit before Tax		2,80,000
VII.	Tax Expense (Tutorial Note)		Nil
VIII.	**Net Profit After Tax**		2,80,000

Tutorial Note : No information is available for tax. Therefore, it had been taken as Nil.

Working Notes :

(1) Calculation of Sales / Revenue from Operations

Gross Profit Ratio = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100 = 25\%$

Gross Profit = ₹ 12,50,000 (given). Therefore, Sales = $\frac{12,50,000}{0.25}$ = ₹ **50,00,000**

(2) Calculation of Cost of Goods Sold

Cost of Goods Sold = Sales – Gross Profit = ₹ 50,00,000 – ₹ 12,50,000 = ₹ 37,50,000.

(3) Calculation of Materials and Wages

(a) Materials = 50% of ₹ 37,50,000 = ₹ 18,75,000

(b) Wages = 50% of ₹ 37,50,000 = ₹ **18,75,000**.

(4) Calculation of Inventories and Debtors

(a) Inventories Turnover Ratio = $\frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$

5 Average Inventories = ₹ 37,50,000

or Average Inventories = $\frac{37,50,000}{5}$ = ₹ **7,50,000**

Assuming that opening inventories and closing are same. Therefore, average inventories = closing inventories = ₹ **7,50,000**.

Debt collection period =3 months. Therefore, Debtors = $\frac{50,00,000}{12} \times 3$ = ₹ **12,50,000**

(5) Calculation of Current Assets

Total Current Assets = Inventories + Debtors = ₹ 7,50,000 + ₹ 12,50,000 = ₹ **20,00,000**.

Assuming that there is no cash or bank balance.

(6) Calculation of Current Liabilities

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = 2 : 1$

Current Assets = ₹ 20,00,000. Therefore, Current Liabilities = ₹ 20,00,000 / 2 × 1 = ₹ **10,00,000**.

(7) Calculation of Trade Creditors

Trade Creditors = Materials consumed × $\frac{3}{12}$ = ₹ 18,75,000 × $\frac{1}{4}$ = ₹ **4,68,750**.

(8) Other Current Liabilities

Total current liabilities = Trade creditors + Other current liabilities

Other current liabilities = ₹ 10,00,000 – 4,68,750 = ₹ **5,31,250**.

(9) Calculation of Capital Employed and Fixed Assets

Working Capital = Current Assets – Current Liabilities

= ₹ 20,00,000 – ₹ 10,00,000 = ₹ 10,00,000.

Proprietory Ratio = $\frac{\text{Fixed Assets}}{\text{Capital Employed}} = 80\%$

It means 80% of capital employed has been invested in fixed assets and balance 20% has been invested in working capital and which is ₹ 10,00,000. Therefore, Total Capital Employed = $\frac{10,00,000}{20} \times 100$ = ₹ **50,00,000**

Fixed Assets = 80% of ₹ 50,00,000 = ₹ **40,00,000**.

(10) Calculation of Equity Funds, Preference Share Capital and Debenture

Capital Gearing Ratio = $\frac{\text{Preference Share and Debentures}}{\text{Equity Funds}} = 3 : 7$

Capital Employed = Equity Funds + Preference Shares + Debentures = ₹ 50,00,000.

(a) Equity Funds = $\frac{50,00,000}{10} \times 7$ = ₹ **35,00,000** (b) Preference Share and Debentures = $\frac{50,00,000}{10} \times 3$ = ₹ **15,00,000**

(11) Calculation of Preference Shares and Debentures

Preference Shares to Debentures = 2 : 1.

Total of preference Shares and Debentures = ₹ 15,00,000.

(a) Preference Shares = $\frac{15,00,000}{3} \times 2$ = **₹ 10,00,000**

(b) Debentures = $\frac{15,00,000}{3} \times 1$ = **₹ 5,00,000**

(12) Calculation Equity Share Capital, General Reserve and Profit and Loss Account Balance

Equity funds = Equity Share Capital + Reserves and Surplus = ₹ 35,00,000.

General Reserve and profit and Loss Account to Equity Share Capital = 1 : 4.

(a) General Reserve and Profit and Loss Account = $\frac{35,00,000}{5} \times 1$ = **₹ 7,00,000**

(b) Equity Share Capital = $\frac{35,00,000}{5} \times 4$ = **₹ 28,00,000**

(c) Net profit = 10% of Equity Share Capital = 10% of ₹ 28,00,000 = **₹ 2,80,000**.

(d) General Reserve + Net Profit = ₹ 7,00,000

General Reserve = ₹ 7,00,000 – ₹ 2,80,000 = **₹ 4,20,000**.

Analysis and Interpretation of Ratios

Illustration 75

The following information is obtained from the books of X Ltd.

	2015 (₹)	2014 (₹)
Turnover	30,00,000	24,00,000
Beginning inventory	3,50,000	4,50,000
Purchases	15,00,000	11,00,000
Ending inventory	4,00,000	3,50,000

(a) Compute for each year the inventory turnover ratio; (b) Analyse the results obtained in (a); and (c) What conclusion can be drawn from the above analysis ?

Solution

(a) Calculation of Cost of Goods Sold

Particulars	2015 ₹	2014 ₹
Beginning inventory	3,50,000	4,50,000
Add: Purchases	15,00,000	11,00,000
	18,50,000	15,50,000
Less: Ending inventory	4,00,000	3,50,000
Cost of Goods Sold	14,50,000	12,00,000

Calculation of average inventory

$$\frac{\text{Beginning inventory} + \text{Ending inventory}}{2}$$

2015 : $\frac{(3,50,000 + 4,00,000)}{2}$ = **₹ 3,75,000**

2014 : $\frac{(4,50,000 + 3,50,000)}{2}$ = **₹ 4,00,000**

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

2015 : $\frac{14,50,000}{3,75,000} = 3.87$ Times 2014 : $\frac{12,00,000}{4,00,000} = 3$ Times

(b) **Analysis**

For the current year, inventory turnover ratio has shown favourable trends. Inventory turnover increased from 3.0 to 3.87. But further comparisons should be made with the data of other firms in the same industry.

(c) **Conclusion**

Generally speaking, the higher the turnover ratio is better, because low inventories often suggest a minimal risk of unsaleable goods and indicate efficient use of capital. Yet inventory turnover figures that are well above industry practice may signal the risk for inventory shortages, resulting in poor customer service, and thus the risk of suffering a competitive disadvantage. The final judgement depends on the specific circumstances.

Illustration 76

PQR Ltd has the following data :

	2015 (₹)	2014 (₹)
Monthly average of debtors (net)	8,20,000	7,80,000
Net credit turnover	60,00,000	50,00,000

Terms of sales : 10% discount can be availed of if payment is made within 60 days.

(a) Compute for the year — (1) the debtors turnover ratio; and

(2) the number of days' turnover in debtors.

(b) Analyse the results obtained in (a).

(c) What conclusion can be drawn from the above analysis ?

Solution (a)

$$\text{Debtors' Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Debtors}}$$

(1) $2015 : \frac{60,00,000}{8,20,000} = 7.3 \text{ Times} \quad 2014 : \frac{50,00,000}{7,80,000} = 6.4 \text{ Times}$

(2) Number of days' turnover in debtors

$$= 2015 : \frac{365}{7.3} = 50 \text{ days} \quad 2014 : \frac{365}{6.4} = 57 \text{ days}$$

(b) **Analysis**

(1) The number of days' turnover in debtors dropped from 57 days to 50 days, pointing to a (slight) increase in the efficiency of collection.

(2) The debtors turnover increased from 6.4 to 7.3 times.

(3) Most of the debtors pay their bills during discount period.

(c) **Conclusion**

Debtors are an expensive asset in terms of tied up capital and poorly controlled debtors may also lead to a cost for bad debts. Other things being equal, therefore, the reduction in the collection period for debtors must be welcomed. Enquiry ought to be made, however, into the way in which this has been achieved. If it is through tightening up of credit control procedures it may drive customers away. Examples of this kind of policy might be increasing the evidence of credit worthiness required before credit is given or pressing debtors for payments when they are only marginally overdue. It may also have been achieved by the granting of generous cash discounts for prompt payment. This could be expensive and it should be evaluated to determine whether the expense is worthwhile.

Illustration 77

The following are the current assets and current liabilities of X Co Ltd as on 31.3.2016 :

Current Assets

Inventories ₹ 5,00,000; Debtors ₹ 2,00,000; Investments (short-term) ₹ 60,000.

Current Liabilities

Creditors ₹ 1,19,200; Bank Overdraft ₹ 4,39,200; Provision for taxation ₹ 88,000;
Proposed dividend ₹ 53,600.

(a) You are required to calculate current ratio and liquid ratio.

(b) Why liquidity is desirable ? Write a brief comment on the liquidity of X Co Ltd.

(c) To what extent it is true to say that a company should keep an especially close watch on the current and liquid ratios?

Solution

(a)

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{7,60,000}{7,00,000} = 1.08 : 1$$

$$\text{Liquid ratio} = \frac{\text{Liquid assets}}{\text{Current liabilities}} = \frac{2,60,000}{7,00,000} = 0.37 : 1$$

(b) Liquidity is the desire to hold assets in the form of cash. Liquidity is crucial to survival and success. Liquidity may be desired for the following reasons :
(1) The transactions motive, i.e., to carry out future monetary transactions.
(2) The precautionary motive, i.e., to avoid future uncertainties.
(3) The speculative motive, i.e., to take advantage of movements in the price level.
Comment
X Co Ltd is experiencing liquidity problems. The current ratio of 1.08 to 1 is very low. The liquid ratio of 0.37 to 1 suggests that great problems with short-term finance may be experienced. If the bank overdraft is excluded from current liabilities, the liquid ratio becomes 0.99 to 1 — which is more respectable. However, this highlights the dependence of the company on the bank as a source of working capital. The payment of income tax or dividend will cause the liquidity position to deteriorate.

(c) The current and liquid ratios are the tests of the business's ability to meet its obligations in the short run. A company would expect to pay current obligations out of immediate cash resources or those provided by receipts from debtors. It would be undesirable if creditors could only be paid by an enforced sale of productive plant and machinery or other fixed assets.
It should not be overlooked that it is also undesirable for current and liquid ratios to grow too large. This is a symptom of surplus cash which does imply that expensive resources are being kept idle.

Illustration 78

The information given below relates to ABC Ltd for the year ended 31.12.2015 :
(i) Opening inventories ₹ 60,000; Closing inventories ₹ 75,000; Sales ₹ 10,00,000.
(ii) Rate of inventories turnover : 12 times in the year.

You are asked to :
(1) Calculate the gross profit ratio.
(2) Give reasons for changes in gross profit ratio.
(3) What are the points to be remembered while calculating gross profit ratio ?
(4) State what action should be taken for an unexpected reduction in the gross profit ratio?
(5) The gross profit ratio of a company has gone up from 20% to 25%. What reservations would you have about judging this figure as favourable sign and what other information would you seek before doing so ?

Solution

(1) $$\text{Stock turnover ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}} = 12 \text{ Times}$$

$$\text{Or,} \quad \frac{\text{Cost of goods sold}}{\frac{1}{2}\,(60,000 + 75,000)} = 12$$

Cost of goods sold = 12 × ₹ 67,500 = ₹ 8,10,000.
Gross profit = Sales – Cost of goods sold
= ₹ (10,00,000 – 8,10,000) = ₹ 1,90,000.

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

$$= \frac{1,90,000}{10,00,000} \times 100 = 19\%$$

(2) The reasons for change in gross profit ratio are :
(a) Change in sales value caused by :
(i) change in selling prices;
(ii) change in volume of goods sold.
(b) Change in cost of goods sold caused by :
(i) change in unit cost of goods sold;
(ii) change in volume of goods sold.
(c) Change in valuation of inventories caused by :
(i) change in the value of opening inventories;
(ii) change in the value of closing inventories.

(3) While calculating gross profit ratio, the following should be remembered :
(a) the gross profit ratio is a measure of the basic profit earning potential of the business.
(b) the only ways in which a company can improve its gross profit ratio are to increase sales volume and/or reduce cost of goods sold.
(c) valuation of inventories is crucial in determining cost of goods sold for a period and thus the gross profit.

(4) An unexpected reduction in the gross profit ratio should be taken seriously. It may be the sign of any or all of the following situations on which action should be taken :
(a) Careless inventories control leading to losses and pilferage of inventories;
(b) An error in the inventories taking records.
(c) Defalcation of cash received from sales.
(d) Rising costs which have not been passed on to customers in higher prices.

(5) Insofar as gross profit ratio is regarded as a measure of the effectiveness of the basic profit earning process, an increase is a good thing. The question is whether this is a genuine improvement or whether it represents a recovery from a setback. This could be determined by examining accounts over a series of years from the past.
The gross profit ratio should also be considered in the context of the absolute value of gross profit. A gross profit ratio could be considerably improved by increasing prices to the final customer. If, in a competitive situation, however, this will indicate a more than proportionate decline in sales. In effect, total profitability might be reduced.

Illustration 79

K Ltd manufactures auto parts. The company sells its products to a number of independent distributors who resell the goods to garages and other retail outlets in their areas. K ltd has a policy of having only one distributor in any given geographical area. Distributors are selected mainly on the basis of financial viability. K Ltd is keen to avoid the disruption of sales and loss of credibility associated with the collapse of a distributor.

The company is currently trying to choose between two companies which have applied to be its sole distributor in Noida U.P., a new sales area.

The applicants have supplied the following information :

Particulars		Company A Ltd.			Company B Ltd.		
		2013	2014	2015	2013	2014	2015
Sales	(₹ in Lakhs)	12,80	16,00	20,00	18,05	19,00	20,00
Gross Profit	(%)	22	20	18	23	22	24
Return on Capital Employed	(%)	8	12	16	14	15	16
Current Ratio		1.7 : 1	1.9 : 1	2.1 : 1	1.7 : 1	1.65 : 1	1.7 : 1
Liquid Ratio		1.4 : 1	1.1 : 1	0.9 : 1	0.9 : 1	0.9 : 1	0.9 : 1
Gearing	(%)	15	21	28	29	30	27

Requirement : Using the information provided above, explain which of the companies appears to be the safer choice for the rate of distributors.

Solution

A Ltd is the fastest growing company. Sales are increasing @ 25%. It will serve the interest of K Ltd, if it can maintain this level of growth. Management of A Ltd may be tempted to take risks for achieving higher sales. If their strategy fails, then they may be forced to suspend their business and sales of K Ltd will be affected adversely.

A Ltd.'s drop in gross profit rate may explain the massive increase in sales. To remain profitable, A Ltd must sell higher volume every years which could put the company under strain. B Ltd.'s approach maintaining margins and growing slowly may make it easier to protect its position in the market. A Ltd and B Ltd are carrying on business in the same town. Perhaps B Ltd has maintained its margins in order to provide a better quality of service and it has enabled it to maintain a steady rate of return. A Ltd.'s approach could have created an impression of a cut-price, down-market operation. If this is the case, then A Ltd. should select B Ltd. as their distributor,

Another point of concern is the increase in the current ratio and decline in the quick ratio of A Ltd. It is indicating that inventories levels must be rising. A Ltd will not be able to discharge its short-term obligations and it may create some problems in the operation of the business. However, B Ltd is maintaining steady current ratio and quick ratio and the company will be able to discharge its short-term obligations.

A Ltd.'s quick increase in gearing suggests that the company is borrowing in order to expand. If the company can not achieve desired sales, then the company may face problem in servicing the debts. In future high gearing may hamper the operation of the business of A Ltd.

Considering the above, K Ltd should select B Ltd as their distributor.

Illustration 80

Anil is the managing director of G C Ltd, a small family-oriented company, which manufactured 'soft toys'. His company is a member of a trade association which publishes a monthly magazine. The latest issue of the magazine contains a very brief article based on the analysis of the financial statements published by the 50 companies which manufacture same type of products. This contain the following information :

Average of all companies in the Industries :	
Return on shareholders' equity	33%
Return on total capital employed	29%
Gross profit percentage	30%
Current ratio	1.9 : 1
Inventories velocity	37 days
Debtors' velocity	41 days

G C Ltd.'s latest financial statements are as follows:

Balance Sheet of G.C. Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹ '000)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — Equity Share Capital		20,00
(b) Reserves and Surplus — General Reserve		64,80
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 10% Debentures		30,00
(4) Current Liabilities :		
(b) Trade Payables — Creditors		29,40
TOTAL		1,44,20
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		1,00,00
(2) Current Assets :		
(a) Inventories		19,20
(b) Trade Receivables — Debtors		24,00
(c) Cash and Cash Equivalents — Cash at Bank		1,00
TOTAL		1,44,00

Statement of Profit and Loss for the year ended 31st March, 2016

	Particulars	Note No.	Amount (₹ '000)
	(1)	(2)	(3)
I.	Sales / Revenue from Operations		1,80,00
II.	Other Income		Nil
III.	**Total Revenue (I + II)**		1,80,00
IV.	**Expenses :**		
	Cost of goods sold		1,44,00
	Employee Benefits Expenses		11,00
	Finance Cost		3,00
V.	**Total Expenses**		1,58,00
VI.	**Net Profit (III – V)**		22,00

Requirements :

(i) Calculate each of the ratios listed in the magazine article, using G C Ltd.'s financial statements and comment briefly on G C Ltd.'s performance in comparison to the Industrial average.

(ii) Explain three reasons why it could be misleading to compare G C Ltd.'s ratio with those taken from the article.

Solution (a) **Computation of Ratios**

Name of the Ratio	Method of Computation	Required Ratio
(i) Return on Shareholders' Equity	$\frac{Net\ Profit\ after\ Tax}{Shareholder's\ Equity} \times 100$	$\frac{2200}{8480\ (Note\ 1)} \times 100 = 25.94\%$
(ii) Return on Total Capital Employed	$\frac{Net\ Profit\ before\ Interest}{Capital\ employed} \times 100$	$\frac{2500\ (Note\ 2)}{11480\ (Note\ 3)} \times 100 = 21.78\%$
(iii) Gross Profit Percentage	$\frac{Gross\ Profit}{Sales} \times 100$	$\frac{3600}{18000} \times 100 = 20\%$
(iv) Current Ratio	$\frac{Current\ Assets}{Current\ Liabilities}$	$\frac{4420\ (Note\ 4)}{2940} = 1.50 : 1$
(v) Inventories Velocity	$\frac{Average\ Stock}{Cost\ of\ Goods\ Sold} \times 365$	$\frac{1920\ (Note\ 5)}{14400} \times 365 = 49\ days$
(vi) Debtors' Velocity	$\frac{Debtors}{Sales} \times 365$	$\frac{2400}{18000} \times 365 = 49\ days$

Comments :

Return on Shareholders' Equity

G C Ltd.'s Return on Shareholders' Equity is not as good as the industry's average. Industry's average return is 33% where as G C Ltd.'s return is only 26% (approx.).

Return on Total Capital Employed

G C Ltd.'s Return on Total Capital Employed is also not good. It is far below the industry average. Industry's average return is 29% whereas G C Ltd.'s return is only 22% (approx.). It indicates that the company can not use its funds properly.

Gross Profit Percentage

G C Ltd.'s gross profit percentage is also lower than the industry average. Industry's average is 30% whereas G C Ltd.'s average is merely 20%.

It indicates that a smaller margin is being made for every rupee of sales. Perhaps its cost of production is higher or its selling prices are lower than the average.

Current Ratio

G C Ltd.'s current ratio is moderate, though it is below the industry average. G C Ltd.'s current ratio is 1.5 : 1 and the industry's average is 1.9 : 1 and the difference is not large enough to cause any concern.

Inventories Velocity

In order to improve cash flow most company try to turnover inventories as quick as possible. Industry average is 37 days whereas G C Ltd. is taking 49 days. It indicates that the company is not managing its current assets efficiently.

Debtors' Velocity

G C Ltd. is taking 12 days more than the industry average of 37 days for collecting dues from debtors. The company should try to obtain payment from debtors as soon as possible to avoid liquidity crunch.

Working Notes :

(1) Shareholders' Equity	(₹ '000)	**(2) Net Profit Before Interest**	(₹ '000)
Equity Share Capital	20,00	Net Profit	22,00
General Reserve	64,80	Add: Interest on Debenture	3,00
	84,80		25,00
(3) Total Capital Eqmployed		**(4) Current Assets**	
Shareholders' Equity (Note 1)	84,80	Inventories	19,20
10% Debentures	30,00	Debtors	24,00
	1,14,80	Bank	1,00
			44,20

(5) It is assumed that opening inventories and closing inventories are same. Average inventories is equal to closing inventories.

(b) At the time of comparing the ratios of G C Ltd. with the industry average, the following matters should be taken into consideration.

(i) **Accounting policy**

Accounting policy difference may lead to misleading ratios. Different company may follow different accounting policies, for example one company may follow 'Straight Line Method' of depreciation while another may follow 'Reducing Balance Method'. The effect of such variations may be to produce misleading ratios.

(ii) **Size of the organisation**

G C Ltd is a small company. In the industry there may be very large companies which are enjoying the economies of scale. These companies may get better price from suppliers also because of their bargaining power. G C Ltd is a small company, comparison should really be made only with other similar-sized businesses.

(iii) The third problem arises from differences in product range. G C Ltd. may produce soft toys which is sold at the top end market, at very high prices and in small volume. It will reduce the value of comparisons with the industry average.

Formulae at a Glance

Sl. No.	Name of the Ratio	Method of Computation	For details see Page
1.	Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	20.4
2.	Quick / Liquid Ratio	$\frac{\text{Quick Assets}}{\text{Quick Liabilities}}$	20.5
3.	Debt Equity Ratio	$\frac{\text{Long–term Debts}}{\text{ShareholdersFunds}}$	20.12
4.	Total Assets to Debt Ratio	$\frac{\text{Total Assets}}{\text{Long–term Debt}}$	20.14
5.	Proprietary Ratio	$\frac{\text{Shareholders' Funds}}{\text{Total Assets}}$	20.14
6.	Inventory / Inventories Turnover Ratio	$\frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$	20.16
7.	Debtors Turnover Ratio	$\frac{\text{Credit Sales}}{\text{Average Debtors} + \text{Average Bills Receivable}}$	20.20
8.	Creditors Trunover Ratio	$\frac{\text{Credit Purchases}}{\text{Average Creditors} + \text{Average Bills Payable}}$	20.22
9.	Working Capital Turnover Ratio	$\frac{\text{Turnover}}{\text{Working Capital}}$	20.23
10.	Total Assets Turnover Ratio	$\frac{\text{Net Sales / Turnover}}{\text{Total Assets}} = \text{Number of Times}$	20.24
11.	Gross Profit Ratio	$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$	20.25
12.	Net Profit Ratio	$\frac{\text{Net Profit}}{\text{Net Sales}} \times 100$	20.27
13.	Operating Ratio	$\frac{\text{Cost of Goods Sold} + \text{Operating Expenses}}{\text{Net Sales}} \times 100$	20.30
14.	Return on Capital Employed	$\frac{\text{EBIT}}{\text{Capital Employed}} \times 100$	20.34
15.	Return on Networth	$\frac{\text{Profit after Tax}}{\text{Networth}} \times 100$	20.35

16.	Earnings per Share	$\frac{\text{Net Income after Tax} - \text{Preference Dividend Requirement}}{\text{Number of Equity Shares}}$	20.36
17.	Price Earning Ratio	$\frac{\text{Market Price per Share}}{\text{Earnings per Share}}$	20.36
18.	Dividend Yield Ratio	$\frac{\text{Dividend per Share}}{\text{Market Value per Share}} \times 100$	20.36

KEY POINTS

- Ratio analysis is the most widely used technique for interpreting and comparing financial reports. It analyses financial data from the firm's Profit and Loss Account and the Balance Sheet.
- *Objectives of Ratio Analysis*
  1. To allow comparisons to be made which assist in predicting the future.
  2. To investigate the reasons for the changes.
  3. To construct a simple explanation of a complicated financial statement by its expression in one figure.
- Users of ratios can be classified into two groups — internal and external. Internal group consist of directors, shareholders, partners, managers, etc. External group consist of investors, lenders, suppliers, employees, labour union, customers, etc.
- Liquidity ratios measure the ability of a firm to meet its short-term obligations. Short-term is conventionally viewed as a period up to one year.
- Current Ratio is the relationship between current assets and current liabilities. It is quoted as a single figure (not a percentage).
- The quick ratio is the relationship between quick assets and quick liabilities. Quick assets are all those assets which in the ordinary course of business will be converted into cash. Therefore, quick assets are current assets less inventories and prepaid expenses, i.e., cash, bank, debtors and readily realisable marketable securities.
- Debt-equity Ratio is the ratio between long-term debt and shareholders' funds.

THEORETICAL QUESTIONS

1. What do you mean by Ratio Analysis ? What are the advantages and limitations of ratio analysis?
2. What are the objectives of Ratio Analysis ?
3. Write short notes on : (a) Current Ratio; (b) Debt-Equity Ratio; (c) Total Assets to Debt Ratio; (d) Operating Ratio.
4. State the meaning and significance of :
   (a) Quick Ratio; (b) Debtors Turnover Ratio; (c) Working Capital Turnover Ratio; (d) Gross Profit Ratio.
5. Explain briefly the meaning and significance of (i) operating ratio; and (ii) working capital turnover ratio.
6. The debt-equity ratio of X Ltd is 1:2. Which of the following would increase, decrease or not change the debt-equity ratio: (a) issue of equity shares; (b) cash received from debtors; (c) sale of goods on cash basis; (d) redemption of debentures; (e) purchase of goods on credit.
7. "Accounting ratios may be misleading in the absence of absolute data" — Comment.
8. Who are the uses of accounting ratios ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each statement or answer each question below :

1. Quick Assets = ?
   A Current assets – Prepaid expenses
   B Current assets – Inventories – Prepaid expenses
   C Current assets + Inventories – Prepaid expenses
   D Current assets – Inventories + Prepaid expenses.
2. Ideal Current Ratio = ?
   A 0.75 : 1
   B 1 : 1
   C 2 : 1
   D 4 : 1.

3. Quick Liabilities = ?
   A Current liabilities – Outstanding expenses
   B Current liabilities – Bank overdraft
   C Current liabilities + Bank overdraft
   D Current liabilities + Surplus
4. Debt Equity Ratio = ?

   A $\frac{Total\ \ Debts}{Equity\ \ Share\ \ Capital}$

   B $\frac{Long\ \ Term\ \ Debts}{Shareholders'\ \ Funds}$

   C $\frac{Shareholders' Funds}{Long\ \ Term\ \ Debts}$.
5. Proprietary Ratio = ?

   A $\frac{Equity\ \ Share\ \ Capital}{Total\ \ Assets}$

   B $\frac{Equity\ \ Share\ \ Capital\ +\ Preference\ \ Share\ \ Capital}{Fixed\ \ Assets}$;

   C $\frac{Shareholders' Funds}{Total\ \ Assets}$.

PRACTICAL QUESTIONS

Calculation of Ratios

1. From the information given below, calculate :
   (i) Working Capital;
   (ii) Capital Employed;
   (iii) Current Ratio;
   (iv) Acid Test Ratio; and
   (v) Debt Equity Ratio.

Balance Sheet of ABC Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :		
Equity Share Capital		1,50,000
12% Preference Share Capital		30,000
(b) Reserves and Surplus		24,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 15% Debentures		48,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		12,000
(b) Trade Payables — Sundry Creditors		16,000
(b) Short-term Provisions — Proposed Dividend		2,000
Provision for Taxation		10,000
TOTAL		2,92,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		2,32,000
(2) Current Assets :		
(a) Inventories		44,000
(b) Trade Receivables — Sundry Debtors		10,000
(c) Cash and Cash Eqivalents — Cash at Bank		6,000
TOTAL		2,92,000

2. The following are abridged accounting reports prepared for X Ltd :

X Ltd.
Statement of Profit and Loss for the year ended 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. Revenue from Operations / Sales (all on Credit)		3,00,000
II. Other Income		Nil
III. **Total Income (I + II)**		3,00,000
IV. **Expenses :**		
Cost of goods sold		2,25,000
Operating Expenses		57,000
V. **Total Expenses**		2,82,000
VI. Profit before Tax (III – V)		18,000
VII. Provision for Tax		8,000
VIII. **Profit After Tax**		10,000

Balance Sheet of X Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital		80,000
(b) Reserves and Surplus — General Reserve		30,000
Undistributed Profit		15,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — Mortgage Loan		25,000
(4) Current Liabilities :		
(a) Trade Payables — Sundry Creditors		87,000
(b) Short-term Provisions — Provision for Tax		8,000
(c) Other Current Liabilities — Outstanding Expenses		5,000
TOTAL		2,50,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant		15,000
Buildings		65,000

(2) Current Assets :		
(a) Inventories		80,000
(b) Trade Receivables — Sundry Debtors		60,000
(c) Cash and Cash Equivalents — Cash in Hand		30,000
TOTAL		2,50,000

Name and calculate the ratios which indicates :

(a) the rapidity with which accounts receivable are collected;
(b) the ability of the company to meet its current obligations;
(c) what profitability on capital invested has been attained;
(d) the efficiency with which funds represented by inventories are being utilised and managed;
(e) the ability of the company to meet quickly demands for payment of accounts due; and
(f) the relative importance of proprietorship and liabilities as source funds.

3. Following items appear in the accounts of X Ltd. as on 31st March, 2016 :

Particulars	₹	Particulars	₹
Cash	48,600	Bank Overdraft	52,000
Land and Building, at cost	8,00,000	Equity Shares of ₹ 10	10,00,000
Deposit and Payments in advance	62,000	Profit and Loss Account	2,17,000
Inventories	3,72,800	Proposed Equity Dividend (2015-16)	86,250
Trade Creditors	4,05,750	Trade Investment	20,000
General Reserve	1,00,000	Provision for Taxation	1,24,000
Debtors	5,23,000	Dividend Reserve	1,40,000
Bills Receivables	22,600	Bills Payable	18,000
Plant at cost less depreciation	5,44,000	Net Sales for the year 2015-16	21,82,400
10% Debentures (repayable 2018)	2,50,000	Net Profit for the year 2015-16 (before tax & dividends)	3,27,830

The value of all fixed assets reflect current price levels and adequate depreciation has been provided.

You are required to arrange the above items in the form of a financial statement to show the following accounting ratios which should be stated :

(a) Return on capital employed; (b) Inventories : Fixed Assets; (c) Current Assets : Current Liabilities; and (d) Sales : Debtors and Receivables.

4. From the following annual statements of Pioneer Ltd., calculate the following ratios :

(a) Gross Profit Ratio; (b) Current Ratio; (c) Liquid Ratio; and Debt Equity Ratio.

Pioneer Ltd.
Statement of Profit and Loss for the year ended 31st March, 2016

	Particulars	Note No.	Amount (₹)
	(1)	(2)	(3)
I.	Sales / Revenue from Operations		85,000
II.	Other Income :		
	Profit on Sale of Investments		600
	Interest on Investments		300
III.	**Total Income (I + II)**		85,900
IV.	**Expenses :**		
	Cost of goods sold		49,575
	Carriage Inward		1,425
	Employee Benefit Expenses		18,000
	Financial Expenses		1,500
	Other Expenses		400
V.	**Total Expenses**		70,900
VIII.	**Net Profit (III – IV)**		15,000

Balance Sheet of Pioneer Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital — 2,000 Equity Shares of ₹ 10 each		20,000
(b) Reserves and Surplus — General Reserve		9,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings		6,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		3,000
(b) Trade Payables :		
Creditors for Expenses		2,000
Other Creditors		8,000
TOTAL		48,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Buildings		15,000
Plant		8,000
(2) Current Assets :		
(a) Inventories		14,000
(b) Trade Receivables :		
Debtors		7,000
Bills Receivables		1,000
(c) Cash and Cash Equivalents — Cash in Hand		3,000
TOTAL		48,000

5. The following extracts of financial information relate to Curious Ltd. (figures in ₹ lakhs) :

Balance Sheet as at 31st December	2015	2014
Share Capital	10	10
Reserves and Surplus	30	10
Loan Funds	60	70
	100	90
Fixed Assets (Net)	30	30
Current Assets		
Inventoriess	30	20
Debtors	30	30
Cash and Bank Balances	10	20
Other Current Assets	30	10
	100	80
Less: Current Liabilities	30	20
Net	70	60
Total Assets	100	90
Sales (₹ Lakhs)	270	300

(i) Calculate, for the two years Debt Equity Ratio, Quick Ratio and Working Capital Turnover Ratio; and
(ii) Find the sales volume that should have been generated in 2015 if the company were to have maintain its Working Capital Turnover Ratio.

6. The Balance Sheet of Y Ltd. stood as follows as on :

Balance Sheet of Y Ltd. as at 31st March, 2016

Particulars	Note No.	31.3.2016 (₹ in Lakhs)	31.3.2015 (₹ in Lakhs)
(1)	(2)	(3)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		250	250
(b) Reserves and Surplus — General Reserve		56	30
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			
(a) Long-term Borrowings		100	120
(4) Current Liabilities :			
(a) Trade Payables — Creditors		100	20
(b) Other Current Liabilities		29	5
TOTAL		535	425
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		260	200
(b) Non-current Investments		40	30
(2) Current Assets :			
(a) Inventories		120	100
(b) Trade Receivables — Debtors		70	50
(c) Cash and Cash Equivalents — Cash at Bank		20	20
(d) Other Current Assets		25	25
TOTAL		535	425

You are given the following information for the year 2015-16 :
Sales 600; PBIT 150; Interest 24; Provision for Tax 60; Proposed Dividend 30.
All the figures given above are rupees in lakhs.
From the above particulars, calculate for the year 2015-16: (a) Return on Capital Employed Ratio; (b) Inventories Turnover Ratio; (c) Return on Networth Ratio; (d) Current Ratio; (e) Proprietory Ratio.

7. A business furnishes you with the following details :

(i) Opening Inventories		50,000
(ii) Closing Inventories		70,000
(iii) Sales :		
Credit		2,10,000
Cash		1,50,000
(iv) Gross Profit		60,000
(v) Year end Debtors	20,000	
Less: Provision for Bad Debts	2,000	18,000
(vi) Year end Bills Receivable		15,000

A year may be taken to be of 360 days. You are asked to :
(i) Work out inventories turnover and debtors turnover ratios; (ii) calculate the operating cycle and state its significance.

[C.A. (Inter) — November, 1999]

Calculation of Different Items of Profit and Loss Account and Balance Sheet

8. Important ratios of a firm for the year 2015 are given below :

1. Inventories velocity	4
2. Debt collection period	2 months
3. Creditors payment period	73 days

4. Gross Profit . . . ₹ 2,00,000
5. Gross Profit margin . . . 20%
6. Cash and Bank balance . . . 5% of sales
7. Credit purchases . . . 25%.

The firm expects an increase of 50% in sales in the ensuing year.
Estimate the working capital requirement of the firm for the ensuing year.

9. From the following ratios and information relating to the activities of Bengal Traders Ltd., find out (a) Sales for the year 2015; (b) Sundry Debtors on 31.12.2015; (c) Sundry Creditors on 31.12.2015; and (d) Closing Inventories : Debtors' velocity 3 months; Inventories velocity 6 months; Creditors' velocity 2 months; Gross Profit ratio 20%. Gross profit for the year ended 31st December, 2015 was ₹ 5,00,000. Inventories as on 31st December, 2015 was ₹ 20,000 higher than that of the opening inventories. Bills Receivable and Bills Payable were ₹ 60,000 and ₹ 36,667 respectively at the end of the year.

Preparation of Balance Sheet and Statement of Proprietors' Fund

10. From the following details available, prepare a summarised Balance Sheet of ABC Ltd., as at 31st December, 2015:
    Fixed assets to Networth . . . 0.75 : 1
    Current Ratio . . . 5 : 2
    Acid Test Ratio . . . 3 : 2
    Reserves included in the Proprietors' Fund . . . 1 : 4
    Current Liabilities . . . ₹ 2,00,000
    Cash and Bank balances . . . ₹ 10,000
    Fixed Assets . . . ₹ 6,00,000.
11. Shri Devdas asks you to prepare his Balance Sheet from the particulars furnished hereunder :
    Inventories velocity 6; Gross profit margin 20%; Capital turnover ratio 2; Fixed assets turnover ratio 4; Debt collection period 2 months; Creditors payment period 73 days; Gross Profit was ₹ 60,000; Excess of closing inventories over opening inventories was ₹ 5,000; Difference in Balance Sheet represents bank balance.
12. Prepare a Balance Sheet from the particulars furnished hereunder :

Inventories velocity 6	Fixed assets turnover 4
Gross profit margin 20%	Debt collection period 2 months
Capital turnover ratio 2	Creditors payment period 73 days
Gross profit ₹ 60,000	Excess of closing inventories over opening inventories was ₹ 5,000
Difference in Balance Sheet represents bank balance	The entire sales and purchases are made on credit basis

[Delhi University B.Com. (Hons.) — 2001]

13. Based on the following information of the financial ratios prepare Balance Sheet of Star Enterprises Ltd as of December 31, 2015. Explain your workings and assumptions :

Current Ratio 2.5	Ratio of gross profit to sales 20%
Liquidity Ratio 1.5	Turnover ratio to net fixed assets 2
Net Working Capital ₹ 6,00,000	Average debt collection period 2.4 months
Inventories Turnover Ratio 5	Long-term debt to capital and reserve 7/25
Fixed assets to networth 0.8	

14. From the following information, prepare the Balance Sheet of Rameshpathy as on 31.3.2016 :
    Fixed Assets . . . ₹ 6 lacs
    Working capital . . . ₹ 4 lacs
    Current ratio . . . 2
    Fixed assets to turnover . . . 4
    G.P. . . . 25%
    Debtors' velocity . . . 1.5 months
    Creditors' velocity . . . 2 months
    Inventories . . . 2 months
    Net profit . . . 5% of turnover
    Reserve . . . 2/3 of net profits
    Capital gearing . . . 1 : 1.

15. From the following information of X Engineering Co., computethe proforma Balance Sheet if its sales are ₹ 16,00,000.

Sales to Networth 2.3 times	Current Ratio 2.9 times
Current Liabilities to networth 42%	Sales to closing inventory 4.5 times
Total Liabilities to networth 75%	Average collection period 64 days

Proforma Balance Sheet

Liabilities	₹	Assets	₹
Networth	?	Fixed Assets	?
Long-term Liabilities	?	Cash	?
Current Liabilities	?	Inventories	?
		Sundry Debtors	?

Calculations are to be the nearest rupee.

16. From the following information, make out a statement of proprietors' fund with as many details as possible :

(i) Current Ratio 2.5	(iv) Working Capital ₹ 60,000
(ii) Liquid Ratio 1.5	(v) Reserve and Surplus ₹ 40,000
(iii) Proprietory Ratio (fixed assets / proprietory fund) .75	(vi) Bank Overdraft ₹ 10,000
	(vii) There is no long term loan or fictitious assets

17. Following are the ratios relating to the trading activities of an organisation :

Debtors velocity	3 months
Inventories velocity	4 months
Creditors velocity	2 months
Gross Profit Ratio	25%
Capital turnover ratio	3
Fixed assets turnover ratio	4

Gross Profit for the year ended 31st March, 2016 was ₹ 7,50,000. Inventories as on 31st March, 2016 was ₹ 30,000 more than it was on 1st April, 2015. At the end of the year Bills Payable and Bills Receivable were ₹ 45,000 and ₹ 50,000 respectively and Bank Overdraft was ₹ 1,10,000. Make necessary assumptions that you think. Prepare the Statement of Proprietory Fund for the year ended 31st March, 2016.

18. The Balance Sheet of Major Limited as on 31st March, 2016 is as under :

Balance Sheet of Major Limited as at 31st March, 2016

Particulars		Note No.	Amount (₹)
(1)		(2)	(3)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital :			
2,000 Equity Shares of ₹ 100 each fully paid			2,00,000
1,000, 7% Preference Shares of ₹ 100 each fully paid			1,00,000
(b) Reserves and Surplus — General Reserve			60,000
(2) Share Application Money Pending Allotment :			—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 12% Debentures			60,000
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors			80,000
TOTAL			5,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Plant and Machinery	5,00,000		
Less: Accumulated Depreciation	1,60,000		3,40,000

(2) Current Assets :		
(a) Inventories (b) Trade Receivables — Debtors (c) Cash and Cash Equivalents — Cash in Hand		60,000 80,000 20,000
TOTAL		5,00,000

The company wishes to forecast Balance Sheet as on 31st March, 2017.

The following additional particulars are available :

(i) Fixed assets costing ₹ 1,00,000 have been installed on 1.4.2016 but the payment will be made on 31.3.2017.

(ii) The fixed asset turnover ratio on the basis of gross value of fixed assets would be 1.5.

(iii) The inventories turnover ratio would be 14.4 (calculated on the basis of average inventories).

(iv) The break-up of cost and profit would be as follows :

Materials	40%
Labour	25%
Manufacturing expenses	10%
Office and selling expenses	10%
Depreciation	5%
Profit	10%
	100%

The profit is subject to interest and taxation at 50%.

(v) Debtors would be 1/9 of sales.

(vi) Creditors would be 1/5 of material consumed.

(vii) In March 2016, a dividend @ 10% on equity capital would be paid.

(viii) 12% Debentures for ₹ 25,000 have been issued on 1.4.2016.

Prepare the forecast Balance Sheet as on 31st March, 2017 and show the following resultant ratios :

(a) Current Ratio; (b) Fixed Assets / Networth Ratio; and (c) Debt Equity Ratio.

Preparation of Profit and Loss Account and Balance Sheet

19. With the help of information given below, prepare Statement of Profit and Loss and Balance Sheet of Sunshine Ltd. (a) Gross Profit ratio 25%; (b) Net Profit / Sales 20%; (c) Sales Inventory ratio 10; (d) Fixed Assets / Total Current Assets 5/8; (e) Current ratio 1; (f) Fixed asset /Share Capital 5/4; (g) Fixed Assets ₹ 8 lakhs; (h) Closing inventories ₹ 80,000. (Assume that there was no balance of any reserves and surplus other than the balance of Profit and Loss Account of current year).

20. The financial information of Good Luck Ltd. for the year 2015 are given below :

Ratio of Current Assets to Current Liabilities	1.75 to 1
Liquidity Ratio (Debtors and Bank balance to current liabilities)	1.25 to 1
Issued Capital (equity shares of ₹ 10 each)	₹ 1,20,000
Net Current Asstes (as over current liabilities)	₹ 60,000
Fixed Assets (net block) percentage of shareholders' equity as on the closing date	60%
Gross Profit (percentage of turnover)	20%
Annual rate of turnover of inventories (based on cost on 31.12.2015)	5.26 times
Average age on outstanding debtors for the year 2015	2 months
Net Profit (percentage on issued share capital)	16%

On 31st December, Current Assts consisted of inventories, debtors and bank balances.

You are required to prepare Statement of Profit and Loss and Balance Sheet for the year ending on 31st December, 2015.

[B.Com. (Hons.) — Adapted]

21. From the following information, prepare the projected Trading and Profit and Loss Account for the next financial year ending December 31, 2015 and the projected Balance Sheet as on that date :

Rate of Gross Profit	25%
Net Profit to Equity Capital	10%
Inventories Turnover Ratio	5 times
Average Debt Collection Period	2 months
Creditors velocity	3 months
Current ratio	2
Proprietory ratio (fixed assets to capital employed)	80%

Capital gearing ratio (Preference Shares and Debentures to Equity) 30%
General Reserve and Profit and Loss to issued Equity Capital 25%
Preference Share Capital to Debentures 2
Cost of sales consists of 40% for materials and balance for Wages and Overheads. Gross Profit ₹ 6,00,000. Working notes should be clearly shown.

22. Complete the following annual financial statement on the basis of ratios given below :

Dr. Profit and Loss Account for the year ended 30th June, 2016 Cr.

Particulars	₹	Particulars	₹
To Cost of goods sold	6,00,000	By Sales	20,00,000
To Operating expenses			
To Earnings before interest and tax			
To Debenture Interest	10,000	By Earnings before Interest and Tax	
To Income Tax			
To Net Profit			

Balance Sheet as at 30th June, 2016

Liabilities	₹	Assets	₹
Networth		Fixed Assets	
Share Capital		Current Assets :	
Reserve and Surplus		Cash	
10% Debentures		Inventories	
Sundry Creditors	60,000	Debtors	35,000

(i) Net Profit to Sales 5%
(ii) Current Ratio 1.5
(iii) Return on Networth 20%
(iv) Inventory turnover (based on cost of goods sold) 15 times
(v) Share capital to reserves 4 : 1
(vi) Rate of income-tax 50%

Analysis and Interpretation of Ratios

23. From the following information of Sakoor Ltd., for the year ending 31st March, 2016 examine the details from the point of view of (i) Solvency position and (ii) Profitability position. Also comment on the condition of the business.

Balance Sheet of Sakoor Ltd. as at 31st March, 2016

Particulars	Note No.	Amount (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital :		
1,20,000 Equity Shares of ₹ 10 each fully paid		12,00,000
80,000, 8% Preference Shares of ₹ 10 each fully paid		8,00,000
(b) Reserves and Surplus — General Reserve		1,00,000
Profit and Loss Account		2,00,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		
(a) Long-term Borrowings — 5% Debentures		5,00,000
(4) Current Liabilities :		
(a) Short-term Borrowings — Bank Loan		50,000
(b) Trade Payables — Sundry Creditors		9,00,000
(c) Short-term Provisions — Provision for Tax		50,000
TOTAL		38,00,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets :		
Plant and Machinery		10,00,000
Land and Building		10,00,000
Furniture and Fixtures		6,00,000
(2) Current Assets :		
(a) Inventories		6,00,000
(b) Trade Receivables : Sundry Debtors		
Bills Receivables		3,80,000
(c) Cash and Cash Equivalents — Cash in Hand		2,00,000
		20,000
TOTAL		38,00,000

Statement of Profit and Loss for the year ended 31st March, 2016

	Particulars	Note No.	Amount (₹)
	(1)	(2)	(3)
I.	Sales / Revenue from Operations		21,00,000
II.	Other Income — Interest		10,000
III.	**Total Income (I + II)**		21,10,000
IV.	**Expenses :**		
	Cost of materials consumed		14,00,000
	Employee Benefits Expense		4,10,000
	Total Expenses		18,10,000
V.	Profit before exceptional and extraordinary items and tax (III – IV)		3,00,000
VI.	Exceptional Items		—
VII.	Profit before extraordinary items and tax		—
VIII.	Extraordinary items		—
IX.	Profit before tax		3,00,000
X.	Tax expense		Nil
XI.	**Profit for the period**		3,00,000

24. The Balance Sheet of Pilcom Ltd. for the last 3 years read as below (all figures in ₹ lakhs) :

	2014	2015	2016
Sources			
Share Capital (shares of ₹ 10)	2,000	2,000	3,000
Share Premium	1,500	1,500	500
Reserves (after 10% dividend)	1,500	1,700	1,800
Long Term Loan	1,000	800	800
	6,000	6,000	6,100
Represented by			
Fixed Assets	2,000	2,500	3,000
Less: Depreciation	700	950	1,250
	1,300	1,550	1,750
Capital Work in progress	800	900	700
Investments	200	200	200
	2,300	2,650	2,650
Net Current Assets			
Current Assets :			
Debtors	1,700	1,800	1,850
Inventoriess	1,800	1,900	2,400
Cash and Bank	500	500	500
Others	400	600	1,400

Current Liabilities	4,400 700	4,800 1,450	6,150 2,700
	3,700	3,350	3,450
Total Assets	6,000	6,000	6,100
Sales	3,900	4,000	5,000

Sales excludes excise duty and sales tax at 20%.
Calculate for the years 2015 and 2016 : (i) Fixed Assets Turnover Ratio; (ii) Inventories Turnover Ratio; (iii) Debtors Turnover Ratio in terms of number of day's sales; (iv) Earnings per share.
Briefly comment on the performance of the company.

Guide to Answers

Multiple Choice

1. B; 2. A; 3. B; 4. B; 5. C.

Practical Questions

1. (i) Working Capital : Gross ₹ 60,000; Net ₹ 20,000; (ii) Capital Employed ₹ 2,00,000 (₹ 1,52,000 proprietors' fund + ₹ 48,000 debentures); (iii) Current Ratio 1.5 : 1; (iv) Acid Test Ratio 0.4 : 1 (it is assumed that overdraft is payable immediately); (v) Debt Equity : 0.32 : 1 (shareholders' equity – ₹ 2,04,000 – 48,000 – 4,000).

2. (a) Name of the ratio is 'Debtors Velocity Ratio'. Ratio is 5 times or 73 days.
(b) Name of the ratio is 'Current Ratio'. Ratio is 1.70 : 1.
(c) Name of the ratio is 'Return on Networth'. Ratio is 8%.
(d) Name of the ratio is 'Inventories Turnover Ratio'. Ratio is 2.5 times or 146 days.
(e) Name of the ratio is 'Quick Ratio'. Ratio is 0.9 : 1.
(f) Name of the ratio is 'Debt Equity Ratio'. Ratio is 0.2 : 1.

3. Return on capital employed — 20.67% (capital employed = share capital ₹ 10,00,000 + general reserve ₹ 1,00,000 + Dividend Reserve ₹ 1,40,000 + Profit and Loss Account ₹ 2,17,000 + 10% Debenture ₹ 2,50,000 = ₹ 17,07,000).
(b) Inventories : Fixed Assets = 0.28 : 1
(c) Current Assets : Current Liabilities = 1.50 : 1.
Current Assets = Cash ₹ 48,600 + Deposit and Payments in advance ₹ 62,000 + Inventories ₹ 3,72,800 + Debtors ₹ 5,23,000 + Bills Receivables ₹ 22,600 = ₹ 10,29,000.
Current Liabilities = Trade creditors ₹ 4,05,750 + Bank overdraft ₹ 52,000 + Proposed Dividend ₹ 86,250 + Provision for tax ₹ 1,24,000 + Bills Payable ₹ 18,000 = ₹ 6,86,000.
(d) 4 Times.

4. (a) Gross Profit Ratio = 40%; (b) Current Ratio = 1.92 : 1; (c) Liquid Ratio = 0.85 : 1 (overdraft is payable on demand); (d) Debt Equity Ratio = 0.21 : 1.

5. (i) Debt Equity Ratio — 2011 : 1.5 : 1; 2010 : 3.5 : 1.
Quick Ratio — 2011 : 2.3 : 1; 2010 : 3 : 1.
Working Capital Turnover Ratio — 2011 : 3.86 Times; 2010 : 5 Times.
(ii) Required sales ₹ 350 lakhs.

6. (a) Capital Employed = Capital + Reserve + Loans – Miscellaneous Expenses.
2011-12 = 250 + 116 + 100 – 60 = 406 lakhs.
2011-12 = 250 + 100 + 120 – 70 = 400 lakhs.

Average Capital Employed $\frac{(406 + 400)}{2} = 403 \text{ Lakhs}$

Return on Capital Employed $= \frac{PBIT}{Average\ Capital\ Employed} = \frac{150}{403} \times 100 = 37.22\%$

(b) Inventories Turnover Ratio = 5.45 Times (based on sales)
(c) Return on Nerworth Ratio = 22.53%.
(d) Current Ratio = 1.82 : 1 (Investment has been taken as long term assets)
(e) Proprietory Ratio = 0.57 : 1 (Networth to total assets).

7. (i) Inventories Turnover Ratio = 5 Times; Debtors Turnover Ratio 6 Times.
(ii) Operating Cycle Period = $\left(\frac{360}{5} + \frac{360}{6}\right) = 72 + 60 = 132 \text{ days}$

8. Working Capital requirement is ₹ 5,75,000.

9. (a) Sales ₹ 25,00,000; (b) Sundry Debtors ₹ 5,65,000; (c) Sundry Creditors ₹ 3,00,000; (d) Closing Inventories ₹ 10,10,000.

10. Total of Balance Sheet ₹ 11,00,000; Share Capital ₹ 6,00,000; Reserves ₹ 2,00,000; Long-term Liabilities ₹ 1,00,000.

11. Cash at Bank ₹ 31,500; Total of Balance Sheet ₹ 1,99,000.

12. Total of Balance Sheet ₹ 1,99,000; Capital ₹ 1,50,000 (based on capital turnover = Net Sales / Capital); Fixed Assets ₹ 75,000; Cash and Bank ₹ 31,500 (balancing figure); Creditors ₹ 49,000; Closing Inventories ₹ 42,500; Debtors ₹ 50,000.

13. Total of Balance Sheet ₹ 39,000.

14. **Total of Balance Sheet ₹ 14,00,000; Fixed Assets ₹ 6,00,000; Inventories-in-trade ₹ 18,750; Debtors ₹ 18,750; Cash in Hand ₹ 7,62,500; Total Current Assets ₹ 8,00,000; Capital ₹ 4,87,500; Reserve ₹ 5,000; Profit and Loss Account ₹ 7,500; Term Loan ₹ 5,00,000; Creditors ₹ 18,750; Other Current Liabilities ₹ 3,81,250; Sales ₹ 1,50,000.**
15. **Networth ₹ 6,95,652; Current Liabilities ₹ 2,92,174; Long-term Liabilities ₹ 2,29,565.**
16. **Proprietors' Fund ₹ 2,40,000; Application of Fund : Fixed assets ₹ 1,80,000; Working capital ₹ 60,000; Inventories ₹ 55,000; Other liquid assets ₹ 45,000; Creditors ₹ 10,000.**
17. **Proprietors' Fund ₹ 10,00,000; Total assets ₹ 22,65,000; Long-term Loans ₹ 7,75,000.**
18. **Total of Forecasted Balance Sheet ₹ 5,69,300**
19. **Gross Profit ₹ 2,00,000; Net Profit ₹ 1,60,000; Total of Balance Sheet ₹ 20,80,000; Long-term Liabilities Nil.**
20. **Gross Profit ₹ 53,126; Net Profit ₹ 19,200; Fixed Assets ₹ 90,900; Inventories ₹ 40,400; Debtors ₹ 44,272; Cash ₹ 56,728; Current Liabilities ₹ 80,800; Reserve and Surplus ₹ 31,500.**
21. **Gross Profit ₹ 6,00,000; Net Profit ₹ 1,06,400; Total of Balance Sheet ₹ 22,80,000.**
22. **Balance Sheet Total ₹ 6,60,000.Fixed assets ₹ 5,70,000; Cash ₹ 15,000; Inventories ₹ 40,000; Debtors ₹ 35,000.**
23. **(i) Debt equity ratio 0.22 : 1; (ii) Capital gearing ratio 0.87 : 1; (ii) current ratio 1.2 : 1; (iv) Quick ratio 0.6 : 1 (overdraft is payable on demand); (v) Inventories turnover ratio 2.8 times; (vi) Gross Profit ratio 33.33%; (vii) Net Profit ratio 14.29%; (viii) Return on networth 13.04%.**
24.

	2015	2016
(i)	**2.80 times**	**3.30 times (based on average fixed assets)**
(ii)	**2.16 times**	**2.33 times (based on sales)**
(iii)	**133 days**	**111 days**
(iv)	**₹ 2.00**	**₹ 1.33**

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Cash Flow Statement

Introduction

A company's Balance Sheet and Statement of Profit and Loss cannot provide any information in respect of inflows and outflows of cash during a particular accounting period.

A Statement of Cash Flow provide vital information about the cash flows of an entity during a particular accounting period.

In order for a company to survive, the ability to make profits may not be enough. It is also important for the company to generate sufficient cash for its survival. Company must pay great attention to ***liquidity*** as well as ***profitability*** if they are to succeed. Negative cash flows for more than one accounting period is a strong sign of potential problems that can affect company's operations as well as financing and investing activities. Therefore, cash flow statement is extremely useful for proper financial planning and control.

Statement of Principles of Financial Reporting developed by the Accounting Standards Board in the U.K. recognises that "Users of financial statements need information on liquidity, viability and financial adaptability of the entity concerned. Deriving this information involves the users in making assessments of the future cash flows of the entity. Accrual accounting used in producing profit and loss (or income and expenditure) accounts and balance sheets, adjusts cash flows to measure results for a period and this is the primary basis for projections. Nevertheless, long-term provisions and other allocations associated with accrual accounting need to be eliminated in order to reveal the lead and lags in historical cash flows, thereby improving understanding of a reporting entity's cash generating or cash absorption mechanisms and providing a basis for the assessment of future cash flows".

Advantages of Cash Flow Statement

1. It provides information about an entity's liquidity, flexibility and ability to generate future cash flows, which is critically important to survival and to successful growth.
2. It can provide information about an entity's ability to meet its obligations as they become due.
3. It enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments of the same transactions and events.

4. It helps to assess the reliability of the amount of net profit.
5. It can account for the difference between net profit and net cash flow from operating activities.
6. The statement enables users to assess why assets and liabilities are increased or decreased during an accounting period.
7. It can provide information concerning cash and non-cash, financing and investing transactions during an accounting period.
8. It will help in assessing likely future financing needs.
9. It will help in assessing the effect of major events such as issue of shares or acquiring another business on the liquidity of the business.

Limitations of Cash Flow Statement

1. The meaning of the word 'cash' is not clearly and precisely expressed. Also, the cash balance of a firm is too easily influenced by postponing cash receipts and cash payments.
2. Since cash is a part of the working capital, the statement does not show changes in working capital at a glance.
3. Cash flow statement does not reflect cash flows where accrued incomes and expenses are involved.
4. There may be a wide difference between the net profit and cash from operations, since a number of 'non-cash' items would affect the net profit of an enterprise. This might create confusion in the minds of the readers.

Distinction between Cash Flow Statement and Funds Flow Statement

	Cash Flow Statement		**Funds Flow Statement**
1.	It summarises the effect of cash on operating, investing and financial activities of a business for an accounting period.	1.	It focuses changes in working capital during an accounting period.
2.	It is concerned with cash.	2.	It is concerned with working capital.
3.	It is based on cash basis.	3.	It is based on accrual basis.
4.	It is required for short-term planning.	4.	It is required for long-term planning.
5.	It shows the cash generated from operations.	5.	It shows funds generated from operations.
6.	It shows changes in working capital items (debtors, stock, creditors, bills receivable and bills payable, etc.) more clearly.	6.	It shows the changes in working capital at a glance.

Preparation of Cash Flow Statement

The cash flow statement shall be prepared in accordance with the Accounting Standard on 'Cash Flow Statement — (AS-3)' issued by the Institute of Chartered Accountants of India. AS-3 is mandatory for the following enterprises in respect of accounting periods commencing on or after April 1, 2004.

(a) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India or outside, and enterprises that are in the process of issuing equity or debt securities that will be so listed as evidenced by the Board of Directors' resolution in this regard.

(b) Banks including co-operative banks.

(c) Financial institutions.

(d) Enterprises carrying on insurance business.

(e) All other commercial, industrial and business enterprises whose turnover (i.e., excluding other income) for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 50 crores or which have borrowings including public deposits exceeding ₹ 10 crores at any time during the accounting period.

(f) Holding and subsidiary enterprises of any of the above at any time during the accounting period.

Definitions

In order to prepare cash flow statement in accordance with AS—3, it is necessary to understand the meaning of different terms which have been used in this standard. The following items have been used in this standard with the meanings specified:

1. Cash : Cash comprises cash in hand and demand deposits with banks.

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

3. Cash Flows : Cash flows are inflows and outflows of cash and cash equivalents.

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

5. Investing Activities : Investing activities are the acquisition and disposal of long-term assets not included in cash equivalents.

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

Cash and Cash Equivalents

Cash is anything which a banker can accept as a deposit at its face value. Cash includes notes and coins, money orders, demand deposits, cheques, bank drafts, etc.

Cash equivalents are "short-term, highly liquid investments which are readily convertible into known amount of cash and which are subject to an insignificant risk of change in value." Thus, an investment is a cash equivalent only if it is readily convertible to a known amount of cash, is subject to an insignificant risk of changes in value, and has a short maturity of three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they clearly satisfy the above criteria. For example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity) can be included in cash equivalent but investment in equity shares can not be included in cash equivalents because of high risk of change in value

Cash and cash equivalents are clubbed together since the essential characteristics of both are almost the same in terms of their liquidity and insignificant risk of change in value. Therefore, the cash flow statement does not show movements between items, cash and cash equivalents.

Examples of cash equivalent include :

1. Bank Overdrafts;
2. Borrowings (repayable on demand);
3. Bank and non-bank Bills of Exchange;
4. Money market instruments with a maturity of three months or less from the date of acquisition.

It is to be noted that the following items would not be considered as cash equivalents :

1. Accounts receivables;
2. Accounts payables;
3. Investments in share portfolios;
4. Deposits with a maturity date greater than three months from the date of cacquisition.

It should be noted that any advances from banks or overdraft repayable within a very short period must be adjusted before calculating the amount of cash and cash equivalents.

Format of Cash Flow Statement as per AS—3

AS—3 lays down a format for the cash flow statement which identifies separately the main activities resulting in cash inflows or outflows. The standard requires that three separate categories of cash flow should normally be shown in the cash flow statement.

These are : 1. Operating Activities
2. Investing Activities
3. Financing Activities

Operating Activities

Cash flows from operating activities are derived from the principal revenue-producing activities of the enterprises.

The examples are :

(a) Cash receipts from the sale of goods and the rendering of services;
(b) Cash receipts from royalties, fees, commissions and other revenue;
(c) Cash payments to suppliers for goods and services;
(d) Cash payments to and on behalf of employees;
(e) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
(g) Cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of cash flows arising from investing activities are:

(a) Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;
(b) Cash receipts from disposal of fixed assets (including intangibles);
(c) Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
(d) Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);
(e) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
(f) Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
(g) Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
(h) Cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Financing Activities

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are :

(a) Cash proceeds from issuing shares or other similar instruments;
(b) Cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and
(c) Cash repayments of amounts borrowed;
(d) Payment of dividends;
(e) Payment of interest.

Some Special Items

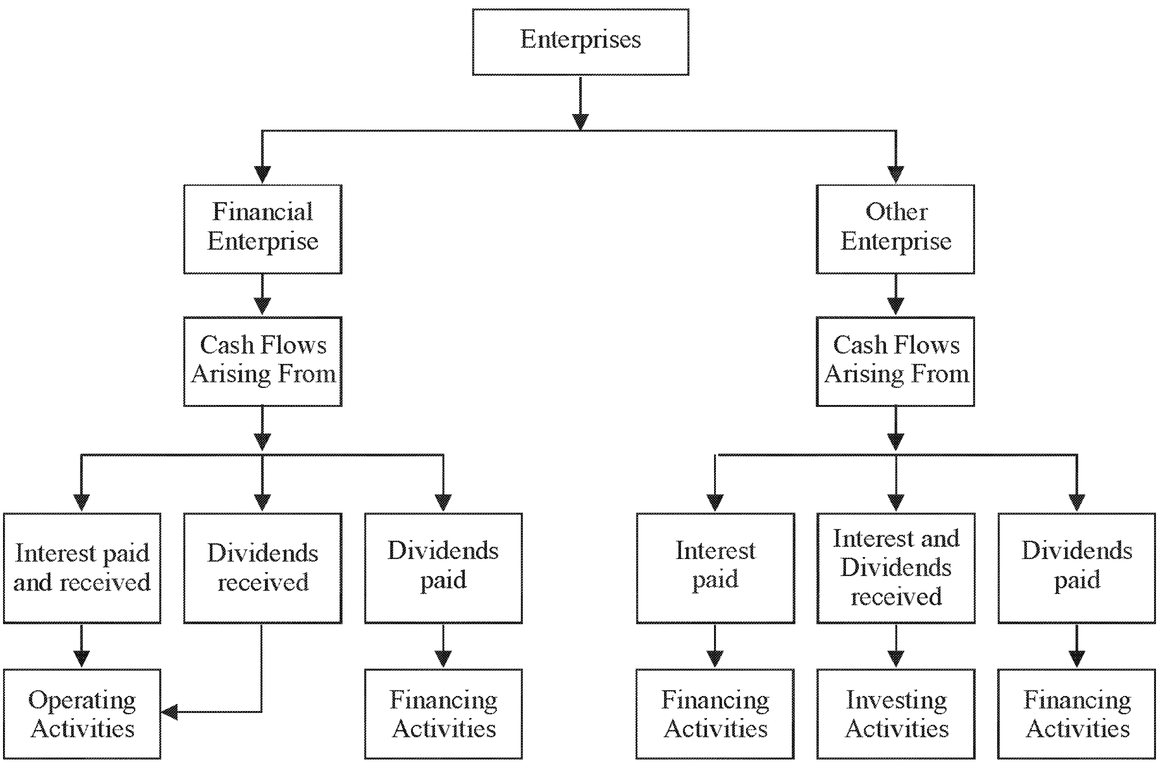
Interest and Dividend

Interest and dividend shall be classified as follows :

For a financial enterprise : Interest paid and received, dividend received as operating activities; and Dividend paid as financing activities.

For other enterprises : Interest and dividend received as investing activities; Interest and dividend paid as financing activities.

The following diagram will clear the matter.



Interest and dividends are received from investments. Naturally, they should be classified as cash inflows from investment activities (in case of other enterprises).
It should be noted that interest and dividend received from short-term investments included in cash and cash equivalents should be considered as cash inflows from operating activities. Similarly, any interest received on advance to employees, suppliers should be treated as cash inflows from operating activities.
Interest paid on long term loan and dividend paid on equity / preference shares should be treated as cash outflows for financing activities. But interest on overdue payment, interest on overdraft etc. should be treated as outflows from operating activities.
In examination, interest and dividend should be treated in the usual manner until and unless it is specifically mentioned that these are related to short-investments, advances to employees or suppliers, etc.

Income-tax

Cash flows arising from taxes on income should be separately disclosed and should be classified as ***cash flows from operating activities*** unless they can be specifically identified with financing and investing activities.

Similarly, income tax refund should be treated as cash inflow from operating activities and to be shown separately.

Extraordinary items

Cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate. It should be disclosed separately.

Acquisitions and Disposals of Subsidiaries and other Business Units

The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as ***investing activities***.

In respect of the above, it should also disclose total purchase consideration and proportion of consideration discharged by cash and cash equivalents.

Foreign Currency Cash Flows

Foreign currency cash flows should be converted at the exchange rate of the ***date of cash flow***. Exchange gain/loss on cash and cash equivalents held in foreign currency will be reported as part of reconciliation of change in cash and cash equivalents for the period. In other words, any loss or gain on account of foreign currency transaction should be ***reconciled with cash balances and not shown in the profit and loss account***.

Cash Flows from Future Contracts, Forward Contracts, Option Contracts and Swap Contracts

Cash flows arising from futures, forward option and swap contracts shall be treated as cash flow from Investing Activities unless —

(i) it is held for dealing / trading purposes (if it is held for dealing / trading purposes, it will be classified as operating activities);
(I) it can be classified as financing activities.

Non-Cash Transactions

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities. Examples of non-cash transactions are :

(i) purchase of assets by issue of shares;
(ii) conversion of debentures into shares.

Calculating Cash Flows

For the purpose of preparing cash flow statement we must know how to calculate or derive the figures to be shown on the statement. In this section, we will show how the different figures are calculated for each categories of cash flow (e.g., operating activities; investing activities; and financing activities).

Net Cash Flows from Operating Activities

There are two methods which can be employed to calculate net cash flow from operating activities :

(a) Direct Method; and

(b) Indirect Method.

AS—3 allows enterprises to calculate the net cash flows from operating activities using either method. Whichever method is adopted, same figure for net cash flows should be derived.

Direct Method **:** Under this method, the required figure is calculated by employing information contained within the ***accounting records*** of the enterprise. These records are used to identify cash movements relating to operating activities.

To calculate net cash flows from operating activities, the following format can be used:

Calculation of Net Cash Flows from Operating Activities

Particulars	₹	₹
Cash Sales		* * *
Cash received from Customers		* * *
Less :		* * *
Cash Purchases	* * *	
Cash Paid to Suppliers	* * *	
Cash Expenses (e.g., wages and salaries, rent, rates and taxes, etc.)	* * *	* * *
Net Cash Flows from Operating Activities		* * *

Illustration 1

From the following information calculate net cash flows from operating activities :

Particulars	₹
1. Purchases :	
Cash	6,00,000
Credit	2,00,000
2. Wages Paid	1,00,000
3. Salaries Paid	50,000
4. Depreciation on Plant	20,000
5. Loss on Sales of Plant	5,000
6. Sales :	
Cash	9,00,000
Credit	1,00,000
7. Interest Received	20,000
8. Profit on Sale of Investments	30,000

All credit sales and purchases were made during the last quarter of the financial year. Therefore, no cash was paid to creditors or collected from debtors during the year.

You are required to calculate Cash Flows from Operating Activities by adopting Direct Method.

Solution **Calculation of Net Cash Flows from Operating Activities**
[Direct Method]

Particulars	₹	₹
Cash Sales		9,00,000
Cash Received from Customers		—
		9,00,000
Less: Cash Purchases	6,00,000	
Cash paid to Suppliers	—	
Cash Expenses (Wages + Salaries)	1,50,000	7,50,000
Net Cash Flows from Operating Activities		1,50,000

Illustration 2

From the following summarised Cash Book of Green View Ltd calculate Net Cash Flows from Operating Activities.

Dr. **Summarised Cash Book** **Cr.**

Date	Particulars	₹ '000	Date	Particulars	₹ '000
2015			2016		
April 1	To Balance b/d	50		By Payment to Suppliers	2,600
	To Receipts from Customers	3,000		By Purchase of Plant	400
	To Issue of Shares	1,000		By Wages and Salaries	200
	To Sale of Plant	450		By Rent, Rates and Taxes	100
				By Income Tax	50
				By Dividends	100
				By Repayment of Bank Loan	150
			March 31	By Balance c/d	900
		4,500			4,500

Solution **Green View Ltd.**

Calculation of Net Cash Flows from Operating Activities [Direct Method]

Particulars	₹ ('000)	₹ ('000)
Cash receipts from Customers	3,000	
Cash payments to Suppliers	(2,600)	
Cash paid to Employees (Wages and Salaries)	(200)	
Other Cash Payments (for rent, rates and taxes)	(100)	
Cash Generated from Operations	100	
Income taxes paid (Note 1)	(50)	
Net Cash from Operating Activities		50

Working Note : **(1)** Income tax paid to be shown separately.

Indirect Method *:* Under this method, the required figure is calculated by employing information contained in the ***Profit and Loss Account and Balance Sheet***. This method does not use information contained within the accounting records of the enterprise.

The 'net profit before taxation' figure in the accounts provides the starting point for calculations. For calculating cash flows from operating activities, certain adjustments are to be made in the net profit before "taxation". The different adjustments are discussed below :

1. ***Depreciation*** : At the time of calculating profit/loss, depreciation is debited to Profit and Loss Account of the enterprise. It will not involve any movement of cash. This is simply a book entry. Therefore, depreciation is to be ***added back*** for calculating cash flows from Operating Activities.

2. ***Profit or Loss on Sale of Fixed Assets*** : For calculating profit/loss, loss on sale of fixed asset is debited to Profit and Loss Account. Similarly, profit on sale of fixed asset is credited to Profit and Loss Account. It will not involve any movement of cash. These are simply book entries. Therefore, loss on sale of fixed asset is to be ***added back*** and profit on sale of fixed asset is ***to be deducted*** for arriving at the cash flows from Operating Activities.

> ***Sale proceeds of fixed asset will, of course, result in a cash inflow but this inflow will be shown in the Cash Flow Statement under Cash Flows from Investing Activities.***

3. Interest Paid / Received : Interest paid / received may also appear in the Profit and Loss Account of an enterprise. Although these items will result in cash movements, they must nevertheless be adjusted for calculating cash flows from Operating Activities because these items will be dealt with elsewhere in the Cash Flow Statement.

4. ***Stocks, Debtors and Creditors*** : Change in the level of stocks, debtors and creditors must also be taken into account for calculating cash flow from operating activities. A decrease in stock or debtors will increase

the cash inflow from operating activities. Whereas an increase in stock or debtors will decrease the cash inflow from operating activities. Similarly, a decrease in creditors will reduce cash. Again, an increase in creditors will effectively increase the cash available to the enterprise.

5. ***Bills Receivable and Bills Payable*** : Just like debtors, a decrease in bills receivable will increase the cash inflow from operating activities. Whereas an increase in the bills receivable will decrease the cash inflow from operating activities.

Like creditors, a decrease in bills payable will reduce cash. Similarly, an increase in bills payable will effectively increase the cash available to the enterprise.

6. ***Prepaid Expenses and Outstanding Expenses*** : A decrease in prepaid expenses will increase the cash inflow from operating activities. Conversely an increase in the prepaid expenses will decrease the cash inflow from operating activities.

A decrease in outstanding expenses will reduce cash. Similarly an increase in outstanding expenses will effectively increase the cash available to the enterprise.

Summary of Effect of Different Items on Cash Inflow

Item	Increase / Decrease	Effect on Inflow
1. Stocks	Decrease Increase	↑ Increase ↓ Decrease
2. Debtors	Decrease Increase	↑ Increase ↓ Decrease
3. Creditors	Decrease Increase	↓ Decrease ↑ Increase
4. Bills Receivable	Decrease Increase	↑ Increase ↓ Decrease
5. Bills Payable	Decrease Increase	↓ Decrease ↑ Increase
6. Prepaid Expenses	Decrease Increase	↑ Increase ↓ Decrease
7. Outstanding Expenses	Decrease Increase	↓ Decrease ↑ Increase

To calculate Net Cash Flows from Operating Activities (under Indirect Method) the following format can be used :

Calculation of Net Cash Flows from Operating Activities

Particulars	₹	₹
Net Profit before Taxation		***
Add back :		
Depreciation on fixed assets	***	
Loss on sale of fixed assets	***	
Interest paid	***	***
		***
Deduct :		
Profit on sale of fixed assets	***	
Interest received	***	***
Cash Generated from Operations Before Working Capital Changes		***
(Increase) / Decrease in Stocks	***	
(Increase) / Decrease in Debtors	***	
Increase / (Decrease) in Creditors	***	
(Increase) / Decrease in Bills Receivable	***	
Increase / (Decrease) in Bills Payable	***	
(Increase) / Decrease in Prepaid Expenses	***	
Increase / (Decrease) in Outstanding Expenses	***	***
Net Cash Flows from Operating Activities		***

Bracket indicates negative figures.

Illustration 3

Calculate net cash flows from operating activities from the following information :

Particulars	2014 (₹)	2015 (₹)
Stock	60,000	50,000
Debtors	25,000	23,000
Creditors	32,000	28,000
Expenses Outstanding	3,500	4,500
Bills Payable	35,000	22,000
Profit and Loss Account	80,000	90,000

Solution **Calculation of Net Cash Flows From Operating Activities**

Particulars	₹	₹
Profit for the year 2015 (₹ 90,000 – ₹ 80,000)		10,000
Decrease in stock (Note 1)	10,000	
Decrease in debtors (Note 2)	2,000	
Decrease in creditors (Note 3)	(4,000)	
Increase in expenses outstanding (Note 4)	1,000	
Decrease in bills payable (Note 5)	(13,000)	(4,000)
Net Cash Flows from Operating Activities		6,000

Working Notes :

(1) Stock in 2014 was ₹ 60,000 but in 2015, it was ₹ 50,000. Therefore, stock was decreased by ₹ 10,000 and it will increase cash flow by ₹ 10,000. (Because sale of stock will generate cash)

(2) Balance of Debtors in 2014 was ₹ 25,000 but in 2015, it was ₹ 23,000. Therefore, balance of debtors was decreased by ₹ 2,000 and it will increase cash flow by ₹ 2,000. (Because collection from debtors will generate cash)

(3) Balance of Creditors in 2014 was ₹ 32,000 but in 2015, it was ₹ 28,000. Therefore, balance of creditors was decreased by ₹ 4,000 and it will decrease cash flow by ₹ 4,000. (Because payment will lead to outflow of cash)

(4) Balance of expenses outstanding in 2014 was ₹ 3,500 but in 2015 it was ₹ 4,500. Therefore, balance of expenses outstanding was increased by ₹ 1,000 and it will increase cash flow by ₹ 1,000. (Because it will prevent outflow of cash)

(5) Balance of bills payable in 2014 was ₹ 35,000 but in 2015 it was ₹ 22,000. Therefore, balance of bills payable was decreased by ₹ 13,000 and it will decrease cash flow by ₹ 13,000. (Because payment will lead to outflow of cash)

Illustration 4

Calculate net cash flows from operating activities from the following :

(i)	Profits made during the year ₹ 2,50,000 after considering the following items :	₹
	(a) Depreciation on fixed assets	10,000
	(b) Amortisation of goodwill	5,000
	(c) Transfer to General Reserve	7,000
	(d) Profit on sale of land	3,000

(ii) The following is the position of current assets and current liabilities :

Particulars	2015 (₹)	2014 (₹)
Debtors	15,000	12,000
Creditors	10,000	15,000
Bills Receivable	8,000	10,000
Prepaid Expenses	4,000	6,000

Solution **Calculation of Net Cash Flows From Operating Activities**

Particulars	₹	₹
Profit for the year 2015 after transferring to General Reserve		2,50,000
Add: Transferred to General Reserve		7,000
		2,57,000
Add back :		
Depreciation on fixed assets	10,000	
Amortisation of goodwill	5,000	15,000
		2,72,000

Deduct :		
Profit on sale of land		3,000
Cash Generated from Operations before Working Capital Changes		2,69,000
Increase in debtors	(3,000)	
Decrease in creditors	(5,000)	
Decrease in bills receivable	2,000	
Decrease in prepaid expenses	2,000	(4,000)
Net Cash Flows from Operating Activities		2,65,000

Illustration 5

Calculate net cash flows from operating activities from the following Profit and Loss Account :

Particulars	₹	Particulars	₹
Salaries	14,000	Gross Profit	52,000
Rent	10,000	Profit on sale of Land	9,000
Provision for Bad Debts	2,000	Income Tax Refund*	3,000
Depreciation	3,000		
Goodwill written-off	2,500		
Loss on sale of Plant	1,500		
Provision for Tax	6,000		
Proposed Dividends	7,000		
Net Profit	18,000		
	64,000		64,000

Solution **Calculation of Net Cash Flows From Operating Activities**

Particulars	₹	₹
Profit for the year		18,000
Add back :		
Provision for bad debts	2,000	
Depreciation	3,000	
Goodwill written-off	2,500	
Loss on sale of plant	1,500	
Provision for tax	6,000	
Proposed dividends	7,000	22,000
		40,000
Deduct :		
Profit on sale of land	9,000	
Income tax refund*	3,000	12,000
Cash Generated from Operations before Working Capital Changes		28,000
Income tax refund		3,000
Net Cash Flows from Operating Activities		31,000

Tutorial Note : *Income tax refund will be shown separately.

Advantages of Direct Method

1. This method shows in details of the actual sources and uses of the cash flows. It assist to understand the way the company generates and uses cash.
2. This method provides information useful in estimating future cash flows.
3. This method shows more clearly that profits are not cash. Therefore, it helps to clear many doubts of the users of financial statements.
4. All figures are easily verifiable and free from bias.

Advantages of Indirect Method

1. This method shows the change in working capital items (e.g., stock, debtors) more clearly.
2. In this method, cash flows can be calculated from published financial statements without going through the accounting records of the enterprise.
3. In view of the amendment to clause 32 of listing agreement, listed enterprises should use only indirect method for preparation and presentation of cash flow.

Distinction between Direct and Indirect Method of Calculating Cash Flows from Operating Activities

	Direct Method		Indirect Method
1.	In this method, major classes of gross cash receipt and gross cash payments are disclosed.	1.	In this method, major classes of gross cash receipts and gross cash payments are not shown. Here, net profit is adjusted for non-cash items like depreciation, goodwill written-off, etc.
2.	Preparation of cash flow under this method requires many figures which will be gathered from accounting record of the enterprise.	2.	Preparation of cash flow under this method will not require any figures from accounting records. Only financial statements are enough for preparation of cash flow.
3.	This method provide detailed information regarding cash generating activities of the enterprise.	3.	This method cannot give detailed information regarding cash generating activities of the enterprise.
4.	Listed companies are not allowed to use this method for preparation and presentation of the cash flow statement (as per amendment in clause 32 of list agreement).	4.	Listed companies are allowed to use this method for preparation and presentation of cash flow statement.

Net Cash Flows from Investing Activities

We have seen earlier that depreciation of fixed assets is adjusted to arrive at the 'Net Cash Flows from ***Operating*** Activities' together with any profit or loss on sale of fixed assets. It should be noted that the purchase of fixed assets and the proceeds from sale of fixed assets are shown under 'Cash Flows from ***Investing*** Activities'. Similarly, sale and purchase of long-term investments are also shown under this heading.

The best way to calculate the figures needed for the cash flow statement under this heading is to prepare respective ledger accounts with available information. All necessary figures will come out from the ledger accounts.

Illustration 6

From the following information calculate the amount of net cash flows from investing activities :

Particulars	2014 (₹)	2015 (₹)
Plant and Machinery	8,50,000	10,00,000
Investments (Long-term)	40,000	1,00,000
Land (at Cost)	2,00,000	1,00,000

Additional information :

(1) Depreciation charged on Plant and Machinery ₹ 50,000.
(2) Plant and Machinery with a book value of ₹ 60,000 was sold for ₹ 40,000.
(3) Land was sold at a profit of ₹ 60,000.
(4) No investment was sold during the year.

Solution **Calculation of Net Cash Flows From Investing Activities**

Particulars	₹	₹
Cash payment to acquire Plant and Machinery (Note 1)	(2,60,000)	
Cash receipts from sale of Plant and Machinery	40,000	
Cash payment to acquire Investments	(60,000)	
Cash receipts from sale of Land [₹ 1,00,000 + ₹ 60,000 (profit)]	1,60,000	
Net Cash Flows from Investing Activities		(1,20,000)

Working Note :

Dr. **(1) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan. 1	To Balance b/d	8,50,000	?	By Bank A/c	40,000
?	To Bank A/c (Purchased — Balancing figure)	2,60,000		By Loss on Sale of Plant & Machinery A/c	20,000
				By Depreciation A/c	50,000
			Dec. 31	By Balance c/d	10,00,000
		11,10,000			11,10,000

Illustration 7

From the following information calculate net cash flows from investing activities. Also calculate the amount of depreciation which is to be adjusted in arriving at net cash flows from operating activities:

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
Machinery (at Cost)	5,00,000	5,50,000
Accumulated Depreciation	1,00,000	1,70,000

During the year 2015, a machinery costing ₹ 50,000 (accumulated depreciation ₹ 20,000) was sold for ₹ 26,000.

Solution **Calculation of Net Cash Flows From Investing Activities**

Particulars	₹	₹
Cash payment to acquire Machinery (Note 1)	(1,00,000)	
Cash receipts from sale of Machinery	26,000	
Net Cash Flows from Investing Activities		(74,000)

₹ 90,000 (Note 2) is to be adjusted in respect of depreciation on machinery in arriving at the net cash flows from operating activities.

Working Notes :

Dr. **(1) Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan. 1	To Balance b/d	5,00,000	?	By Bank A/c	26,000
?	To Bank A/c (Purchased — Balancing figure)	1,00,000		By Loss on Sale of Machinery A/c	4,000
				By Accumulated Depreciation A/c	20,000
			Dec. 31	By Balance c/d	5,50,000
		6,00,000			6,00,000

Dr. **(2) Accumulated Depreciation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan. 1	To Machinery A/c	20,000	Jan. 1	By Balance c/d	1,00,000
Dec. 31	To Balanace c/d	1,70,000	Dec. 31	By Profit and Loss A/c	90,000
		1,90,000			1,90,000

Net Cash Flows from Financing Activities

In this section the receipts from the issue of shares (both equity and preference) and debentures, loans, notes, bonds and other short or long-term borrowings, as well as repayment of loans and redemption of preference shares and debentures are included. Dividends paid and interest paid (in case of non-financing enterprise) are also included in this Section. It is important to note that an increase in shares due to a ***bonus issue*** will not be shown on the cash flow statement, since it is a capitalisation of reserves and not an issue for cash.

When shares are issued at a premium, the cash flow statement will reflect the total cash generated by the issue (i.e., face value of shares *plus* any premium).

Illustration 8

From the following information calculate net cash flows from financing activities :

Particulars	2014 (₹)	2015 (₹)
Equity Share Capital	4,00,000	5,00,000
12% Debentures	1,50,000	1,00,000
Securities Premium	40,000	50,000

Additional information : Interest paid on debentures ₹ 18,000.

Solution **Calculation of Net Cash Flows From Financing Activities**

Particulars	₹	₹
Cash proceeds from the issue of Shares (including premium)	1,10,000	
Interest paid on Debentures	(18,000)	
Cash repayment of Debentures	(50,000)	
Net Cash Flows from Financing Activities		42,000

Illustration 9

X Ltd. provides the following information, calculate net cash flows from financing activities :

Particulars	2014 (₹)	2015 (₹)
Equity Share Capital	5,00,000	6,00,000
14% Debentures	1,00,000	—
12% Debentures	—	2,00,000

Additional information :

(1) Interest paid on debentures ₹ 19,000;

(2) Dividends paid ₹ 50,000;

(3) During the year 2015, X Ltd. issued bonus share in the ratio of 5 : 1 by capitalising reserve.

Solution **Calculation of Net Cash Flows From Financing Activities**

Particulars	₹	₹
Cash proceeds from the issue of Debentures		2,00,000
Cash repayment of Debentures		(1,00,000)
Interest paid	(19,000)	
Dividends paid	(50,000)	(69,000)
Net Cash Flows from Financing Activities		31,000

Tutorial Note : Bonus shares is not shown in the Cash Flow Statement because there is no cash inflow.

Suggested Steps for Preparation of Cash Flow Statement

The students may follow the following suggested steps for preparation of Cash Flow Statement from given Balance Sheets with some adjustments.

Step 1 *:* Set up the requirement format in blank, leaving space to insert details. Use one complete sheet for the statement and another for working notes.

Step 2 *:* Study the additional information below the Balance Sheets and mark the related items in the Balance Sheets.

Step 3 *:* Go through the Balance Sheet line by line from the top. For many items, you simply have to calculate the difference and enter it to the format as an inflow and outflow of cash. There will be some problem items requiring further work. These are :

Sales of fixed assets
Taxation
Dividends

For these items, you open ledger accounts, insert opening and closing balances and leave it for the time being. You will come back to those workings after you have transferred every items from the Balance Sheet to your answer.

Step 4 : Complete all the working notes. Transfer all relevant figures to the main statement.

Step 5 : Complete the main statement.

Format of a Cash Flow Statement

. . . & Co Ltd
Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit before Taxation (excluding extraordinary profit / loss)	* * *	
Add back :		
(i) Depreciation	* * *	
(ii) Goodwill written off	* * *	
(iii) Preliminary expenses written off	* * *	
(iv) Interest expenses (for long-term loan / debentures)	* * *	
(v) Loss on sale of assets, long-term investments	* * *	
(vi) Proposed dividends	* * *	
Less :		
(i) Profit on sale of investment, assets, etc.	* * *	
(ii) Interest income (from long-term investments)	* * *	
(iii) Dividend income (from long-term investments)	* * *	
Cash Generated from Operations Before Working Capital Changes		
Decrease in Debtors / (Increase in Debtors)	* * *	
Decrease in Stocks / (Increase in Stocks)	* * *	
Decrease in Bills Receivable / (Increase in Bills Receivable)	* * *	
Decrease in Prepaid Expenses / (Increase in Prepaid Expenses)	* * *	
Increase in Creditors / (Decrease in Creditors)	* * *	
Increase in Bills Payable / (Decrease in Bills Payable)	* * *	
Increase in Outstanding Expenses / (Decrease in Outstanding Expenses)	* * *	
Cash Generated from Operations		
Income tax paid	* * *	
Net Cash from Operating Activities	* * *	
Profit / (Loss) from Extraordinary Items	* * *	* * *
Cash Flows from Investing Activities		
Purchase of Fixed Assets	* * *	
Purchase of Investments	* * *	
Proceeds from Sale of Fixed Assets	* * *	
Proceeds from Sale of Investments	* * *	
Interest Received	* * *	
Dividend Received	* * *	* * *
Net Cash from Investing Activities		* * *
Cash Flows from Financing Activities		
Proceeds from Issue of Shares including Premium	* * *	
Proceeds from Long-term Loans	* * *	
Proceeds from Issue of Debentures	* * *	
Redemption of Preference Shares	* * *	
Redemption of Debentures	* * *	
Repayment of Loans	* * *	
Interest Paid	* * *	
Dividend Paid	* * *	
Net Cash from Financing Activities		* * *
Net Increase in Cash and Cash Equivalents		* * *
Cash and Cash Equivalents at the Beginning of the Period		* * *
Cash and Cash Equivalents at the End of the Period		* * *

Illustration 10

Raj Ltd. gives you the following information for the year ended 31st March, 2006 :

(i) Sales for the year ₹ 48,00,000. The company sold goods for cash only.
(ii) Cost of goods sold was 75% of sales.
(iii) Closing inventory was higher than opening inventory by ₹ 50,000.
(iv) Trade creditors on 31.3.2006 exceed the outstanding on 31.3.2009 by ₹ 1,00,000.
(v) Tax paid during the year amounts to ₹ 1,50,000.
(vi) Amounts paid to trade creditors during the year ₹ 35,50,000.
(vii) Administrative and selling expenses paid ₹ 3,60,000.
(viii) One new machinery was acquired in December, 2005 for ₹ 6,00,000.
(ix) Dividend paid during the year ₹ 1,20,000.
(x) Cash in hand and at Bank on 31.3.2006 ₹ 70,000.
(xi) Cash in hand and at Bank on 1.4.2005 ₹ 50,000.

Prepare Cash Flow Statement for the period ended 31.3.2006 as per the prescribed Accounting Standard.

[C.A. (PE-II) — May, 2006]

Solution

Raj Ltd.
Cash Flow Statement for the year ended 31st March, 2006

Particulars	₹	₹
Cash Flows from Operating Activities (Direct Method)		
Cash Sales	48,00,000	
Less: Cash paid to Suppliers	(35,50,000)	
Less: Expenses paid	(3,60,000)	
Cash Generated from Operations	8,90,000	
Income-tax paid	1,50,000	
Net Cash from Operating Activities		7,40,000
Cash Flows from Investing Activities		
Purchase of Fixed Assets	(6,00,000)	
Net Cash from Investing Activities		(6,00,000)
Cash Flows from Financing Activities		
Dividend Paid	(1,20,000)	
Net Cash from Financing Activities		(1,20,000)
Net Increase in Cash and Cash Equivalents		20,000
Cash and Cash Equivalents at the Beginning of the Period		50,000
Cash and Cash Equivalents at the End of the Period		70,000

Tutorial Note : Under direct method, change in the items of working capital are not taken into consideration, only cash paid are taken into consideration.

Illustration 11

From the following information, prepare a cash flow statement of A & Co. Ltd. :

Balance Sheets of A & Co. Ltd. as at 31st December, ...

Particulars	Note No.	01.01.2015 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	6,75,000	7,07,500
(b) Reserves and Surplus		1,35,000	3,57,750
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term borrowings — 14% Debentures		1,35,000	2,70,000

(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		—	—
(c) Other Current Liabilities — Outstanding Expenses		1,08,000	2,16,000
(d) Short-term Provisions		—	—
TOTAL		10,53,000	15,51,250
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		6,88,500	8,37,000
(b) Non-current Investments		40,500	1,08,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		—	—
(c) Trade Receivables		—	—
(d) Cash and Cash Equivalents		54,000	2,01,250
(e) Short-term Loans and Advances		—	—
(f) Other Current Assets		2,70,000	4,05,000
TOTAL		10,53,000	15,51,250

Notes to Accounts :

Particulars	01.01.2015 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	4,05,000	5,72,500
12% Preference Shares of ₹ 100 each	2,70,000	1,35,000
	6,75,000	7,07,500

Additional information —

(1) Depreciation charged on Plant and Machinery was ₹ 81,000.
(2) An interim dividend of 15% was paid on equity shares. Additional shares were issued on 31.12.2015.
(3) Preference shares were redeemed at a premium of 15%.
(4) Plant and Machinery with a book value of ₹ 54,000 were sold at ₹ 33,750.
(5) Preference Dividend paid during the year ₹ 32,400.
(6) Debenture interest paid during the year ₹ 18,900.

Solution

A & Co. Ltd.
Cash Flow Statement for the year ended 31st December, 2015

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit (₹ 3,57,750 – ₹ 1,35,000)	2,22,750	
Add back :		
Depreciation of Plant and Machinery	81,000	
Loss on Sale of Plant and Machinery (Note 1)	20,250	
Premium on Redemption of Preference Shares (Note 3)	20,250	
Preference Dividend paid	32,400	
Interest on Debentures paid	18,900	
Interim Dividends	60,750	
Cash Generated from Operations before Working Capital Changes	4,56,300	
Increase in Other Current Assets	(1,35,000)	
Increase in Current Liabilities	1,08,000	
Net Cash from Operating Activities		4,29,300

Cash Flows from Investing Activities		
Cash payment to acquire Plant and Machinery (Note 1)	(2,83,500)	
Cash receipt from sale of Plant and Machinery	33,750	
Cash payment to acquire Investments	(67,500)	
Net Cash from Investing Activities		(3,17,250)
Cash Flows from Financing Activities		
Cash Proceeds from Issue of Shares	1,67,500	
Cash Proceeds from Issue of Debentures	1,35,000	
Cash Paid for Redemption of Preference Shares (Note 2)	(1,55,250)	
Interim Dividend Paid	(60,750)	
Preference Dividend paid	(32,400)	
Interest on Debentures paid	(18,900)	
Net Cash from Financing Activities		35,200
Net Increase in Cash and Cash Equivalents		1,47,250
Cash and Cash Equivalents at the Beginning of the Period		54,000
Cash and Cash Equivalents at the End of the Period		2,01,250

Working Notes :

Dr. **(1) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan. 1	To Balance b/d	6,88,500	?	By Bank A/c	33,750
?	To Bank A/c (Purchased — balancing figure)	2,83,500	?	By Profit and Loss A/c (Loss)	20,250
			Dec. 31	By Depreciation A/c	81,000
			"	By Balance c/d	8,37,000
		9,72,000			9,72,000

Dr. **(2) 12% Preference Share Capital Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
?	To Bank A/c (₹ 1,35,000 + 20,250)	1,55,250	Jan. 1	By Balance b/d	2,70,000
Dec. 31	To Balance c/d	1,35,000	?	By Premium on Redemption	20,250
		2,90,250			2,90,250

(3) Premium paid on redemption of preference shares was charged to Profit and Loss Account at the time of calculating profit. Therefore, it will be added back to calculate cash flows from operating activities.

Illustration 12

From the following Summary Cash Account of X Ltd., prepare Cash Flow Statement for the year ended 31st March, 2016 using the direct method. The Company does not have any cash equivalents.

Summary Cash Account for the year ended 31.3.2016

Particulars	₹ ('000)	Particulars	₹ ('000)
Balance on 1.4.2015	50	Payment to Suppliers	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from Customers	2,800	Overhead Expense	200
Sale of Fixed Assets	100	Wages and Salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.3.2016	150
	3,250		3,250

Solution

X Ltd.
Cash Flow Statement for the year ended 31st March, 2016 (Direct Method)

Particulars	₹ ('000)	₹ ('000)
Cash Flows from Operating Activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Payment of wages and salary	(100)	
Payment of overhead expenses	(200)	
Cash Generated from Operations	500	
Income tax paid	250	
Net Cash from Operating Activities		250
Cash Flows from Investing Activities		
Sale of fixed assets	100	
Purchase of fixed assets	(200)	
Net Cash from Investing Activities		(100)
Cash Flows from Financing Activities		
Dividend paid	(50)	
Repayment of bank loan	(300)	
Proceeds from issue of equity shares	300	
Net Cash from Financing Activities		(50)
Net Increase in Cash and Cash Equivalents		100
Cash and Cash Equivalents at the Beginning of the Period		50
Cash and Cash Equivalents at the End of the Period		150

Illustration 13

The Balance Sheets of Y Ltd at 31st December, 2014 and 2015 were as follows:

Balance Sheets of Y Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	2014 (₹ '000)	2015 (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(3)	300	380
(b) Reserves and Surplus	(7)	500	690
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term borrowings — 10% Debentures	(5)	100	150
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		70	80
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Proposed Dividend	(6)	30	40
TOTAL		1,000	1,340
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Property, Plant and Equipment	(1)	730	1,100
(b) Non-current Investments — at Cost		100	50
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		80	110
(c) Trade Receivables		110	180
(d) Cash and Cash Equivalents		(20)	(100)
TOTAL		1,000	1,340

Reference No. :

1. **Property, Plant and Equipment** : During the year tangible property, Plant and Equipment with a net book value of ₹ 80,000 were sold for ₹ 60,000. The depreciation charge for the year on all property, plant and equipment held at the end of the year was ₹ 1,00,000.
2. **Investments** : Investment which cost ₹ 50,000 were sold during the year for ₹ 40,000.
3. **Issued Capital** : Issued capital at 31st December, 2014 consisted of 3,00,000 equity shares of ₹ 1 each. Another 80,000 shares were issued during the year at a price of ₹ 2.25 per share.
4. **Revaluation Reserve** : Company's property was revalued upwards by ₹ 1,00,000 during the year.
5. **10% Debenture** : ₹ 50,000 of 10% debentures were issued on 1st January, 2015. All interest upto 31st December, 2015 has been paid.
6. **Proposed Dividends** : The proposed dividends are on company's equity share capital. No interim dividends were paid.
7. **Reserve and Surplus**

Reserve and Surplus	2014 (₹ '000)	2015 (₹ '000)
Securities Premium	200	300
Revaluation Reserve	100	200
Accumulated Profit	200	190
	500	690

Prepare a Cash Flow Statement for the year ended 31st December, 2015, complying with AS—3.

Solution

Y Ltd.

Cash Flow Statement for the year ended 31st December, 2015

Particulars	₹ ('000)	₹ ('000)
Cash Flows from Operating Activities		
Net Profit	30	
Add back :		
Depreciation	100	
Loss on Sale of Plant (₹ 80 – 60)	20	
Loss on sale of investments (₹ 50 – 40)	10	
Interest expenses	15	
	175	
Cash Generated from Operations Before Working Capital Changes		
Increase in Inventories	(30)	
Increase in Trade Receivables	(70)	
Increase in Trade Payables	10	
Net Cash from Operating Activities		85
Cash Flows from Investing Activities		
Purchase of Property, Plant and Equipments (Note 2)	(450)	
Proceeds of Sale of Property, Plant and Equipment	60	
Proceeds from Sale of Investments	40	
Net Cash from Investing Activities		(350)
Cash Flows from Financing Activities		
Proceeds from Issue of Shares including Premium	180	
Proceeds from Issue of Debentures	50	
Dividends Paid (Note 3)	(30)	
Interest Paid	(15)	
Net Cash from Financing Activities		185
Net Increase in Cash and Cash Equivalents		(80)
Cash and Cash Equivalents at the Beginning of the Period		(20)
Cash and Cash Equivalents at the End of the Period		[100)

Working Notes :

Dr. **(1) Accumulated Profit Account** **Cr.**

Date	Particulars	₹ ('000)	Date	Particulars	₹ ('000)
31.12.2015	To Proposed Dividend A/c	40	1.1.2015	By Balance b/d	200
31.12.2015	To Balance c/d	190		By Net Profit (Balancing figure)	30
		230			230

Dr. **(2) Property, Plant and Equipment Account** **Cr.**

Date	Particulars	₹ ('000)	Date	Particulars	₹ ('000)
1.1.2015	To Balance b/d	730	31.12.2015	By Depreciation A/c	100
	To Revaluation Reserve A/c	100	"	By Bank A/c	60
	To Bank A/c (Purchased)		"	By Loss on Sale of Plant	20
	(Balancing figure)	450	"	By Balance c/d	1,100
		1,280			1,280

(3) It is assumed that the proposed dividend of 2014 was paid in full in 2015.

Illustration 14

The following are the summarised Balance Sheets of X Ltd. as on March 31, 2015 and 2016 :

Balance Sheets of X Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.31.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	10,00,000	12,50,000
(b) Reserves and Surplus	(2)	4,00,000	4,90,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term borrowings		5,00,000	4,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Sundry Creditors		5,00,000	4,00,000
(c) Other Current Liabilities — Outstanding Expenses		—	—
(d) Short-term Provisions	(3)	1,50,000	1,85,000
TOTAL		25,50,000	27,25,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(4)	12,50,000	14,00,000
(b) Non-current Investments		1,00,000	50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		3,00,000	2,80,000
(c) Trade Receivables		4,00,000	4,20,000
(d) Cash and Cash Equivalents	(5)	5,00,000	5,75,000
TOTAL		25,50,000	27,25,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	10,00,000	12,50,000
(2) Reserve and Surplus		
(i) Capital Reserve	—	10,000
(ii) General Reserve	2,50,000	3,00,000
(iii) Profit and Loss	1,50,000	1,80,000
	4,00,000	4,90,000
(3) Short-term Provisions		
(i) Provision for Taxation	50,000	60,000
(ii) Proposed Dividend	1,00,000	1,25,000
	1,50,000	1,85,000
(4) Tangible Assets		
(i) Land and Building	5,00,000	4,80,000
(ii) Machinery	7,50,000	9,20,000
	12,50,000	14,00,000
(5) Cash and Cash Equivalents		
Cash on Hand	2,00,000	1,65,000
Cash at bank	3,00,000	4,10,000
	5,00,000	5,75,000

Additional information :

(i) Dividend of ₹ 1,00,000 was paid during the year ended March 31, 2016.
(ii) Machinery during the year purchased for ₹ 1,25,000.
(iii) Machinery of another company was purchased for a consideration of ₹ 1,00,000 payable in equity shares.
(iv) Income-tax provided during the year ₹ 55,000.
(v) Company sold some investment at a profit of ₹ 10,000 which was credited in Capital Reserve.
(vi) There was no sale of machinery during the year.
(vii) Depreciation written-off on land and building ₹ 20,000.

From the above particulars, prepare a Cash Flow Statement for the year ended 31st March, 2016, as per AS—3.

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit before Taxation (Note 1)	1,35,000	
Add back :		
Depreciation on Machinery (Note 2)	55,000	
Depreciation on Land and Building	20,000	
Proposed Dividends (Note 4)	1,25,000	
Cash Generated from Operations Before Working Capital Changes	3,35,000	
Increase in Trade Receivables	(20,000)	
Decrease in Inventory	20,000	
Decrease in Trade Payables	(1,00,000)	
Cash Generated from Operations	2,35,000	
Income-tax Paid (Note 3)	(45,000)	
Net Cash from Operating Activities		1,90,000
Cash Flows from Investing Activities		
Purchase of Machinery (Note 2 and 6)	(1,25,000)	
Sale of Investment (Note 5)	60,000	
Net Cash from Investing Activities		(65,000)
Cash Flows from Financing Activities		
Proceeds from Issue of Shares (₹ 2,50,000 – 1,00,000)	1,50,000	
Repayment of Long-term Loans	(1,00,000)	
Dividend Paid (Note 7)	(1,00,000)	

Net Cash from Financing Activities		(50,000)
Net Increase in Cash and Cash Equivalents		75,000
Cash and Cash Equivalents at the Beginning of the Period		5,00,000
Cash and Cash Equivalents at the End of the Period		5,75,000

Working Notes : **(1) Net Profit earned during the year 2015-16**

Particulars	₹
Increase in Profit and Loss (Cr.) balance (₹ 1,80,000 – 1,50,000)	30,000
Add: Transfer to General Reserve	50,000
Add: Income-tax provided during the year	55,000
	1,35,000

Dr. **(2) Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	7,50,000	31.3.2016	By Depreciation (Balancing figure)	55,000
"	To Bank (Purchase)	1,25,000		By Balance c/d	9,20,000
"	To Equity Share Capital	1,00,000			
		9,75,000			9,75,000

Dr. **(3) Provision for Income-tax Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Cash (Balancing figure)	45,000	1.4.2015	By Balance b/d	50,000
31.3.2016	To Balance c/d	60,000	31.3.2016	By Profit and Loss A/c	55,000
		1,05,000			1,05,000

Dr. **(4) Proposed Dividend Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Bank A/c (Note 7)	1,00,000	1.4.2015	By Balance b/d	1,00,000
31.3.2016	To Balance c/d	1,25,000	31.3.2016	By Profit and Loss A/c	1,25,000
		2,25,000			2,25,000

Dr. **(5) Investment Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance c/d	1,00,000	?	By Bank (Sale of Investment)	60,000
	To Capital Reserve (Profit on Sale)	10,000	31.3.2016	By Balance c/d	50,000
		1,10,000			1,10,000

(6) Purchase of machinery by issue of equity shares will not be shown in the Cash Flow Statement because there will be no outflow or inflow of cash.

(7) It is assumed that proposed dividend of 2014-15 has been paid in full in 2015-16.

Illustration 15

The Balance Sheets of X Ltd at 31st December, 2014 and 2015 are given below.

Balance Sheets of X Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹ '000)	31.12.2015 (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	2,000	2,200
(b) Reserves and Surplus	(2)	4,740	6,500
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		1,000	1,500
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		800	700
(c) Other Current Liabilities — Outstanding Expenses		400	500
TOTAL		8,940	11,400

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		6,400	8,500
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,200	1,400
(c) Trade Receivables		1,500	1,400
(d) Cash and Cash Equivalents		(160)	100
TOTAL		8,940	11,400

Notes to Accounts :

Particulars	31.12.2014 (₹ '000)	31.12.2015 (₹ '000)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid-up	2,000	2,200
(2) Reserve and Surplus		
Securities Premium	2,340	2,540
Revaluation Reserve	—	1,000
Accumulated Profit	2,400	2,960
	4,740	6,500

Notes :

(1) **Movement in Fixed Assets** (₹ '000)

Particulars	Land	Buildings	Plant	Total
Cost or Valuation on 1st January, 2015	2,000	3,000	3,400	8,400
Additions	—	—	2,500	2,500
Disposals	—	—	(1,000)	(1,000)
Revaluation	1,000	—	—	1,000
At 31st December, 2015	3,000	3,000	4,900	10,900
Accumulated Depreciation on 1st January, 2015	—	400	1,600	2,000
Depreciation for the year		60	1,140	1,200
Disposals			(800)	(800)
At 31st December, 2015	—	460	1,940	2,400
Net Book Value :				
At 31st December, 2015	3,000	2,540	2,960	8,500
At 31st December, 2014	2,000	2,600	1,800	6,400

(2) ₹ 5,00,000 of 10% debentures was issued on 1st January, 2015. Interest on all debentures is paid on 30th June and 31st December every year.

(3) The company paid a dividend of ₹ 5,00,000 during the year. The proposed dividends have not been recognised as liabilities in the Balance Sheets.

(4) Plant sold during the year realised ₹ 2,50,000.

(5) The tax charged for the year in the Profit and Loss Account was ₹ 5,00,000.

Required : Prepare a Cash Flow Statement of X Ltd for the year ended 31st December, 2015, as per AS—3.

Solution

X Ltd.

Cash Flow Statement for the year ended 31st December, 2015

Particulars	₹ ('000)	₹ ('000)
Cash Flows from Operating Activities		
Net Profit before Taxation (Note 1)	1,560	
Add back :		
Depreciation	1,200	
Interest Expense	150	

	2910	
Less:	50	
Profit on Sale of Machinery (Note 2)	2,860	
Cash Generated from Operations Before Working Capital Changes		
Increase in Inventory	(200)	
Decrease in Trade Receivables	100	
Decrease in Trade Payables	(100)	
Cash Generated from Operations	2,660	
Income tax paid	(400)	
Net Cash from Operating Activities		2,260
Cash Flows from Investing Activities		
Purchase of Plant	(2,500)	
Proceeds of Sale of Plant	250	
Net Cash from Investing Activities		(2,250)
Cash Flows from Financing Activities		
Proceeds from Issue of Shares including Premium	400	
Proceeds from Issue of Debentures	500	
Payment of Dividends	(500)	
Interest Expenses	(150)	
Net Cash from Financing Activities		250
Net Increase in Cash and Cash Equivalents		260
Cash and Cash Equivalents at the Beginning of the Period		(160)
Cash and Cash Equivalents at the End of the Period		100

Working Notes :

Dr. **(1) Accumulated Profit Account** **Cr.**

Date	Particulars	₹ ('000)	Date	Particulars	₹ ('000)
31.12.2015	To Taxation A/c	500	1.1.2015	By Balance b/d	2,400
"	To Dividend A/c	500	31.12.2015	By Net Profit (Balancing figure)	1,560
"	To Balance c/d	2,960			
		3,960			3,960

Dr. **(2) Profit on Sale of Plant** **Cr.**

Particulars	₹ ('000)
Proceeds from Sale of Plant	250
Less: Net Book Value (Note 1) [Movement of fixed assets (₹ 10,00,000 – 8,00,000)]	200
Profit on Sale	50

Illustration 16

The Balance Sheets of M.H.K. Ltd as at 31st March, 2015 and 2016 were as follows:

Balance Sheets of M.H.K. Ltd. as at 31st March, 2015 and 2016.

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		10,00,000	11,00,000
(b) Reserves and Surplus : Securities Premium		8,00,000	9,00,000
Accumulated Profits		4,80,000	5,90,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 6% Loan	(4)	8,00,000	12,00,000
(4) Current Liabilities :			
TOTAL		30,80,000	37,90,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(2)	21,40,000	30,60,000
Less: Accumulated Depreciation		5,80,000	8,40,000
		15,60,000	22,20,000
(2) Current Assets (Net)	(3)	15,20,000	15,70,000
TOTAL		30,80,000	37,90,000

Notes :

1. The net cash generated from operating activities for the year is ₹ 7,46,000 before deducting interest paid on the loan.
2. During the year the company sold fixed assets which had cost ₹ 4,80,000 for ₹ 2,80,000.
3. The net current assets figures include cash at bank:
   31 March 2015 : ₹ 14,000; 31st March 2016 : ₹ 18,000.
   All other movements in net current assets have already been allowed for in computing the net cash inflow from operating activities given in Note 1 above. Dividends paid, when computed, should be included in financing activities.
4. The loan was taken on 1st April, 2015 all interest for the year ended on 31st March, 2016 was paid in the year.
5. The profit for the year ended 31st March, 2016 before allowing for dividends paid was ₹ 2,60,000.
6. Ignore taxation.

Required: Prepare the company's cash flow statement for the year ended 31st March 2016 beginning with the net cash inflow from operating activities given in Note 1 above.

Solution

M.H.K. Ltd.
Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Cash from Operating Activities		7,46,000
Cash Flows from Investing Activities		
Proceeds from Sale of Fixed Assets	2,80,000	
Purchase of Fixed Assets (Note 1)	(14,00,000)	
Net Cash from Investing Activities		(11,20,000)
Cash Flows from Financing Activities		
Proceeds from Issue of Shares including Securities Premium(₹ 1,00,000 + ₹ 1,00,000)	2,00,000	
Proceeds from Long-term Borrowings	4,00,000	
Dividends Paid (Note 2)	(1,50,000)	
Interest Paid (6% of ₹ 12,00,000)	(72,000)	
Net Cash from Financing Activities		3,78,000
Net Increase in Cash and Cash Equivalents		4,000
Cash and Cash Equivalents at the Beginning of the Period		14,000
Cash and Cash Equivalents at the End of the Period		18,000

Working Notes :

Dr. (1) Fixed Assets Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	21,40,000		By Fixed Assets Disposal A/c	4,80,000
"	To Bank A/c	14,00,000	31.3.2016	By Balance c/d	30,60,000
		35,40,000			35,40,000

Dr. (2) Accumulated Profit Account Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Bank (Dividend paid)	1,50,000	1.4.2015	By Balance b/d	4,80,000
31.3.2016	To Balance c/d	5,90,000		By Net Profit	2,60,000
		7,40,000			7,40,000

Illustration 17

The following figures have been extracted from the books of X Limited for the year ended on 31.3.2016. You are required to prepare a Cash Flow Statement.

(i) Net profit before taking into account income tax and income from law suits but after taking into account the following items was ₹ 20 lakhs.
   (a) Depreciation on Fixed Assets ₹ 5 lakhs.
   (b) Discount on issue of Debentures written off ₹ 30,000.
   (c) Interest on Debentures paid ₹ 3,50,000.
   (d) Book value of investments ₹ 3 lakhs (sale of investments for ₹ 3,20,000).
   (e) Interest received on investments ₹ 60,000.
   (f) Compensation received ₹ 90,000 by the company in a suit filed.

(ii) Income tax paid during the year ₹ 10,50,000.

(iii) 15,000, 10% preference shares of ₹ 100 each were redeemed on 31.3.2016 at a premium of 5%. Further the company issued 50,000 equity shares of ₹ 10 each at a premium of 20% on 2.4.2015. Dividend on preference shares were paid at the time of redemption.

(iv) Dividends paid for the year 2014-15 ₹ 5 lakhs and interim dividend paid ₹ 3 lakhs for the year 2015-16.

(v) Land was purchased on 2.4.2015 for ₹ 2,40,000 for which the company issued 20,000 equity shares of ₹ 10 each at a premium of 20% to the land owner as consideration.

(vi) Current assets and current liabilities in the beginning and at the end of the years were as detailed below:

Particulars	As on 31.3.2015 ₹	As on 31.3.2016 ₹
Stock	12,00,000	13,18,000
Sundry Debtors	2,08,000	2,13,100
Cash in Hand	1,96,300	35,300
Bills Receivable	50,000	40,000
Bills Payable	45,000	40,000
Sundry Creditors	1,66,000	1,71,300
Outstanding Expenses	75,000	81,800

Solution

X Limited
Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit before Taxation (excluding extraordinary profit / loss)	20,00,000	
Add back :		
Depreciation on Fixed Assets	5,00,000	
Discount on Issue of Debentures	30,000	
Interest Expenses (Debentures)	3,50,000	
	28,80,000	
Less: Profit on Sale of Investment	(20,000)	
Less: Interest Income from Long-term Investments	(60,000)	
Cash Generated from Operations Before Working Capital Changes	28,00,000	
Increase in Sundry Debtors	(5,100)	
Increase in Stock	(1,18,000)	
Decrease in Bills Receivable	10,000	
Increase in Sundry Creditors	5,300	
Decrease in Bills Payable	(5,000)	
Increase in Outstanding Expenses	6,800	
Cash Generated from Operations	26,94,000	
Income-tax Paid	10,50,000	
Net Cash from Operating Activities	16,44,000	
Cash Flow from Extraordinary Items – Compensation received in a law suit filed	90,000	17,34,000

Cash Flows from Investing Activities		
Proceeds from Sale of Investments	3,20,000	
Interest Received on Investment	60,000	
Net Cash from Investing Activities		3,80,000
Cash Flows from Financing Activities		
Proceeds from Issue of Shares including Securities Premium @ 20%	6,00,000	
Redemption of Preference Shares at 5% Premium	(15,75,000)	
Preference Share Dividend Paid	(1,50,000)	
Interest on Debentures Paid	(3,50,000)	
Dividend Paid (₹ 5,00,000 + 3,00,000)	(8,00,000)	
Net Cash from Financing Activities		(22,75,000)
Net Increase in Cash and Cash Equivalents		(1,61,000)
Cash and Cash Equivalents at the Beginning of the Period		1,96,300
Cash and Cash Equivalents at the End of the Period		35,300

Tutorial Note : Purchase of land for ₹ 2,40,000 by issuing 20,000 equity shares of ₹ 10 each at a premium of 20% has not been shown in the Cash Flow Statement as it does not involve any inflow or outflow of cash.

Illustration 18

The directors of X Ltd have been concerned about the poor financial performance shown in the company's 2014 annual accounts. Extracts from the company's Statement of Profit and Loss and Balance Sheet are as follows:

X Ltd.
Statement of Profit and Loss for the year ended 31st December, 2014

Particulars	Note No.	31.12.2014 (₹)
I. Revenue from Operations (Sales) (all credit)		6,00,000
II. Other Incomes		—
III. Total Revenue (I + II)		6,00,000
IV. **Expenses :**		
Cost of materials consumed (Including Purchases ₹ 5,00,000)		5,40,000
Operating Expenses		40,000
Total Expenses		5,80,000
V. Profits Before Tax (III – IV)		20,000
VI. Provision for Tax		4,000
VII. Net Profit after Tax (VI – V)		16,000
Less: Appropriation :		
Proposed Dividend		4,000
Transferred to Reserve and Surplus		12,000

Balance Sheet of X Ltd. as at 31st December, 2014

Particulars	Note No.	31.12.2014 (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital – Equity Shares of ₹ 10 each		3,00,000
(b) Reserves and Surplus		50,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables — Creditors		90,000
(c) Short-term Provisions	(1)	14,000
TOTAL		4,54,000

II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible Assets		3,20,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,20,000
(c) Trade Receivables — Debtors		60,000
(d) Cash and Cash Equivalents		(46,000)
TOTAL		4,54,000

Notes to Accounts :

Particulars	31.12.2014 (₹)
(1) Short-term Provisions	
Proposed Dividend	10,000
Provision for Taxation	4,000
	14,000

The directors believe that they can improve the performance of the company for 2015 in the following ways:

(i) The closing stock to be taken as ₹ 1,40,000.
(ii) Keep sales at the same level as 2014, but reduce purchases by 10%.
(iii) Decrease the closing debtors by one-fourth compared with the 2014 level.
(iv) Increase the closing creditors by one-third compared with 2014 level.
(v) Sell half of the fixed assets for cash by the end of 2015 at book value (ignore depreciation).
(vi) Operating expenses will be reduced by 5% of their 2014 level.
(vii) Provision for taxation will be 25% of the net profit.
(viii) Proposed dividend will be 10% of the profit transferred to reserves and surplus.

Prepare :

(a) Statement of Profit and Loss for 2015 and the Balance Sheet at the end of 2015.
(b) Cash Flow Statement.

Solution

X Ltd.

Statement of Profit and Loss for the year ended 31st December, 2015

Particulars	Note No.	31.12.2014 (₹)
I. Revenue from Operations (Sales) (all credit)		6,00,000
II. Other Income		—
III. Total Revenue (I + II)		6,00,000
IV. **Expenses :**		
Cost of materials consumed	(1)	4,30,000
Operating Expenses		38,000
Total Expenses		4,68,000
V. Profits Before Tax (III – IV)		1,32,000
VI. Provision for Taxation (25% of ₹ 1,32,000)		33,000
VII. Net Profit after Tax (VI – V)		99,000
Less: Appropriation : Proposed Dividend (1/11 x ₹ 99,000)		9,000
Transferred to Reserve and Surplus		90,000

Balance Sheet of X Ltd. as at 31st December, 2015

Particulars	Note No.	31.12.2014 (₹)
(1)	(2)	(3)
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds :		
(a) Share Capital – Equity Shares of ₹ 10 each		3,00,000
(b) Reserves and Surplus (50,000 + 90,000)		1,40,000
(2) Share Application Money Pending Allotment :		—
(3) Non-current Liabilities :		—
(4) Current Liabilities :		
(a) Short-term Borrowings		—
(b) Trade Payables (90,000 + 1/3 of ₹ 90,000)		1,20,000
(c) Other Current Liabilities — Outstanding Expenses		—
(d) Short-term Provisions	(1)	42,000
TOTAL		6,02,000
II. ASSETS		
(1) Non-current Assets :		
(a) Fixed Assets		
(i) Tangible assets (50% of ₹ 3,20,000)		1,60,000
(2) Current Assets :		
(a) Current Investments		—
(b) Inventories		1,40,000
(c) Trade Receivables (75% of ₹ 60,000)		45,000
(d) Cash and Cash Equivalents (Balancing figure)		2,57,000
TOTAL		6,02,000

Notes to Accounts :

Particulars	31.12.2015 (₹)
(1) Short-term Provisions	
Proposed Dividend	9,000
Provision for Taxation	33,000
	42,000

X Ltd
Cash Flow Statement for the year ended 31st December, 2015

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit	90,000	
Add back :		
Provision for Taxation	33,000	
Proposed Dividend	9,000	
Cash Generated from Operations before Working Capital Changes	1,32,000	
Increase in Stock	(20,000)	
Decrease in Debtors	15,000	
Increase in Creditors	30,000	
	1,57,000	
Income Tax Paid	(4,000)	
Net Cash from Operating Activities		1,53,000
Cash Flows from Investing Activities		
Sale of Fixed Assets		1,60,000

Cash Flows from Financing Activities		
Dividend paid		(10,000)
Net Increase in Cash and Cash Equivalents		3,03,000
Cash and Cash Equivalents at the Beginning of the Period		(46,000)
Cash and Cash Equivalents at the End of the Period		2,57,000

Illustration 19

ABC Ltd gives you the following information. You are required to prepare Cash Flow Statement by using indirect method as per AS—3 for the year ended 31.3.2016:

Balance Sheet of ABC Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share Capital of ₹ 10 each		50,00,000	50,00,000
(b) Reserves and Surplus		26,50,000	36,90,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		—	9,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings — Bank Loan		1,50,000	3,00,000
(b) Trade Payables		8,80,000	8,20,000
(c) Other Current Liabilities	(1)	4,80,000	5,70,000
TOTAL		91,60,480	1,12,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(2)	21,20,000	32,80,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		20,10,000	19,20,000
(c) Trade Receivables	(3)	22,40,000	26,40,000
(d) Cash and Cash Equivalents	(4)	27,00,000	33,20,000
(e) Short-term Loans and Advances		—	—
(f) Other Current Assets — Prepaid Expenses		90,000	1,20,000
TOTAL		91,60,000	1,12,80,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Other Current Liabilities		
Liabilities for Expenses	3,30,000	2,70,000
Dividend Payable	1,50,000	3,00,000
	4,80,000	5,70,000
(2) Tangible Assets		
Plant and Machinery	27,30,000	40,70,000
Less: Depreciation	6,10,000	7,90,000
	21,20,000	32,80,000
(3) Trade Receivables		
Trade Debtors	23,90,000	28,30,000
Less: Provision for Bad Debts	1,50,000	1,90,000
	22,40,000	26,40,000

(4) Cash and Cash Equivalents		
Cash in Hand	15,20,000	18,20,000
Marketable Securities (Maturity period less than 90 days)	11,80,000	15,00,000
	27,00,000	33,20,000

Additional information :

(i) Net profit for the year ended 31st March, 2016, after charging depreciation ₹ 1,80,000 is ₹ 22,40,000.

(ii) Debtors of ₹ 2,30,000 were determined to be worthless and were written off against the provisions for doubtful debts account during the year.

(iii) ABC Ltd.. declared dividend of ₹ 12,00,000 for the year 2015-16.

Solution

ABC Ltd.

Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit	22,40,000	
Add back :		
Depreciation	1,80,000	
Cash Generated from Operations Before Working Capital Changes	24,20,000	
Increase in Debtors	(4,40,000)	
Increase in Provision	40,000	
Decrease in Inventories	90,000	
Increase in Prepaid Expenses	(30,000)	
Decrease in Creditors	(60,000)	
Decrease in Outstanding Expenses	(60,000)	
Net Cash from Operating Activities		19,60,000
Cash Flows from Investing Activities		
Purchase of Plant and Machinery (₹ 40,70,000 – 27,30,000)	(13,40,000)	
Net Cash from Investing Activities		(13,40,000)
Cash Flows from Financing Activities		
Issue of Debentures	9,00,000	
Bank Loan Taken	1,50,000	
Dividend Paid (₹ 12,00,000 – 3,00,000 + 1,50,000)	(10,50,000)	
Net Cash from Financing Activities		Nil
Net Increase in Cash and Cash Equivalents		6,20,000
Cash and Cash Equivalents at the Beginning of the Period (Note 2)		27,00,000
Cash and Cash Equivalents at the End of the Period (Note 2)		33,20,000

Working Notes :

(1) Adjustment for bad debts is to be ignored. Actual balance of debtors and provision for bad debts are to be considered.

(2) Marketable securities is to be treated as cash equivalents.

(3) Retained Earnings:

	₹
Opening balance	26,50,000
Add: Net profit for the year	22,40,000
	48,90,000
Less: dividend declared	12,00,000
Balance as on 31.3.20016	36,90,000

Illustration 20

From the following details relating to the Accounts of Grow More Ltd. prepare Cash Flow Statement:

Balance Sheets of Grow More Ltd. as at 31st March, 2016 and 2015

Particulars	Note No.	31.03.2016 (₹)	31.03.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	10,00,000	8,00,000
(b) Reserves and Surplus	(2)	3,00,000	2,10,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term borrowings — 10% Debentures		2,00,000	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Sundry Creditors		7,00,000	8,20,000
(c) Other Current Liabilities — Outstanding Expenses		—	—
(d) Short-term Provisions	(3)	3,00,000	1,70,000
TOTAL		25,00,000	20,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(4)	13,00,000	9,00,000
(b) Non-current Investments		1,00,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		4,00,000	2,00,000
(c) Trade Receivables — Sundry Debtors		5,00,000	7,00,000
(d) Cash and Cash Equivalents		2,00,000	2,00,000
TOTAL		25,00,000	20,00,000

Notes to Accounts :

Particulars	31.03.2016 (₹)	31.03.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	10,00,000	8,00,000
(2) Reserve and Surplus		
General Reserve	2,00,000	1,50,000
Profit and Loss	1,00,000	60,000
	3,00,000	2,10,000
(3) Short-term Provisions		
Provision for Taxation	1,00,000	70,000
Proposed Dividend	2,00,000	1,00,000
	3,00,000	1,70,000
(4) Tangible Assets		
Plant and Machinery	7,00,000	5,00,000
Land and Building	6,00,000	4,00,000
	13,00,000	9,00,000

Additional information :

(i) Depreciation @ 25% was charged on the opening value of Plant and Machinery.
(ii) During the year one old machine costing ₹ 50,000 (WDV ₹ 20,000) was sold for ₹ 35,000.
(iii) ₹ 50,000 was paid towards income tax during the year.
(iv) Building under construction was not subject to any depreciation.

Prepare Cash Flow Statement as per AS—3.

Solution

Grow More Ltd.
Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit (₹ 1,00,000 – 60,000)	40,000	
Add back :		
Transfer to Reserve	50,000	
Provision for Taxation (Note 1)	80,000	
Proposed Dividend (Note 3)	2,00,000	
Depreciation Written-off	1,25,000	
	4,95,000	
Less: Profit on Sale of Machinery (Note 4)	15,000	
Cash Generated from Operations Before Working Capital Changes	4,80,000	
Decrease in Trade Receivables	2,00,000	
Increase in Inventories	(2,00,000)	
Decrease in Sundry Creditors	(1,20,000)	
Cash Generated from Operations	3,60,000	
Income Tax Paid	(50,000)	
Net Cash from Operating Activities		3,10,000
Cash Flows from Investing Activities		
Purchases of Plant and Machinery (Note 2)	(3,45,000)	
Addition to Building	(2,00,000)	
Purchase of Investment	(1,00,000)	
Sale of Old Machine	35,000	
Net Cash from Investing Activities		(6,10,000)
Cash Flows from Financing Activities		
Proceeds from Issue of Shares	2,00,000	
Proceeds from Issue of Debentures (Note 5)	2,00,000	
Dividend Paid (Note 3)	(1,00,000)	
Net Cash from Financing Activities		3,00,000
Net Increase in Cash and Cash Equivalents		Nil
Cash and Cash Equivalents at the Beginning of the Period		2,00,000
Cash and Cash Equivalents at the End of the Period		2,00,000

Working Notes :

Dr. **(1) Provision for Taxation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Cash A/c	50,000	1.4.2015	By Balance b/d	70,000
31.3.2016	To Balance c/d	1,00,000	31.3.2016	By Profit and Loss A/c (Bal. figure)	80,000
		1,50,000			1,50,000

Dr. **(2) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	5,00,000	31.3.2016	By Depreciation A/c	1,25,000
	To Profit on Sale of Machinery A/c	15,000	?	By Cash A/c (Sale of Machinery)	35,000
?	To Cash A/c (Balancing figure)	3,45,000	31.3.2016	By Balance c/d	7,00,000
		8,60,000			8,60,000

(3) It is assumed that proposed dividend of 2014-15 was paid in 2015-16. Dividend proposed for 2015-16 was debited to Profit and Loss Account ₹ 2,00,000.
(4) Profit on sale of machinery = (₹ 35,000 – ₹ 20,000) = ₹ 15,000.
(5) It is assumed that no interest has been paid for new debentures issued.

Illustration 21

The following are the summarised Balance Sheets of X Ltd. as on 31st December :

Balance Sheets of X Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		4,50,000	7,80,000
(b) Reserves and Surplus — Profit and Loss Account		70,000	1,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		39,000	22,000
(c) Other Current Liabilities — Outstanding Expenses		—	—
(d) Short-term Provisions	(1)	66,000	82,000
TOTAL		6,25,000	9,84,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(2)	3,90,000	7,76,000
(b) Non-current Investments		16,000	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,03,000	1,01,000
(c) Trade Receivables		85,000	1,00,000
(d) Cash and Cash Equivalents		31,000	7,000
TOTAL		6,25,000	9,84,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Short-term Provisions		
Proposed Dividend	40,000	50,000
Provision for Taxation	26,000	32,000
	66,000	82,000
(2) Tangible Assets		
Land and Building (A)	1,80,000	3,60,000
Plant and Machinery (B)	3,00,000	6,10,000
Less: Provision for Depreciation	(90,000)	(1,94,000)
	2,10,000	4,16,000
Total (A + B)	3,90,000	7,76,000

Notes : (1) Summarised Statement of Profit and Loss for 2015 :

Particulars	₹	₹
Net Profit		1,12,000
Less: Provision for Taxation	32,000	
Proposed Dividend	50,000	82,000
Retained Profit for the year		30,000

(2) Plant and machinery which had cost ₹ 45,000 some years ago and had a W.D.V. of ₹ 6,000, was sold during the year for ₹ 8,000.

(3) Investments were sold for ₹ 19,000.

You are required to prepare a Cash Flow Statement (as per AS—3) and give your comments explaining why bank balances have not kept in line with profit.

Solution **Cash Flow Statement for the year ended 31st December, 2015**

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit before Tax and Dividend	1,12,000	
Less : Profit on sale of plant (Note 3)	(2,000)	
Profit on sale of Investments	(3,000)	
	1,07,000	
Add back : Depreciation (Note 2)	1,43,000	
Cash Flows before Working Capital Changes	2,50,000	
Decrease in Inventories (₹ 1,03,000 – ₹ 1,01,000)	2,000	
Increase in Trade Receivables (₹ 1,00,000 – ₹ 85,000)	(15,000)	
Decrease in Trade Payables (₹ 39,000 – ₹ 22,000)	(17,000)	
Cash Generated from Operations	2,20,000	
Tax Paid	(26,000)	
Net Cash from Operating Activities		1,94,000
Cash Flows from Investing Activities		
Purchase of Land and Building	(1,80,000)	
Purchase of Plant and Machinery (Note 1)	(3,55,000)	
Sale of Plant and Machinery	8,000	
Sale of Investments	19,000	
Net Cash from Investing Activities		(5,08,000)
Cash Flows from Financing Activities		
Issue of Shares	3,30,000	
Dividend paid	(40,000)	
Net Cash from Financing Activities		2,90,000
Net Increase in Cash and Cash Equivalents		(24,000)
Cash and Cash Equivalents at the Beginning of the Period		31,000
Cash and Cash Equivalents at the End of the Period		7,000

Working Notes :

Dr. **(1) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan 1	To Balance b/d	3,00,000	?	By Plant & Machinery Disposal A/c	45,000
?	To Bank A/c (Balancing figure)	3,55,000	Dec 31	By Balance c/d	6,10,000
		6,55,000			6,55,000

Dr. **(2) Provision for Depreciation (Plant and Machinery) Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
?	To Plant and Machinery Disposal A/c	39,000	Jan 1	By Balance b/d	90,000
Dec 31	To Balance c/d	1,94,000	Dec 31	By Depreciation A/c	1,43,000
		2,33,000			2,33,000

Dr. **(3) Plant and Machinery Disposal Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
?	To Plant and Machinery A/c	45,000	?	By Provision for Depreciation A/c	39,000
?	To Profit and Loss A/c (Profit)	2,000	?	By Bank A/c (Sales)	8,000
		47,000			47,000

Comments :

A cash flow statement summarises the movements of cash into and out of the business, illustrating the differences between sales and receipts and between expenses and payments. Therefore, cash flow is related only loosely to profit.

A highly profitable business may have an adverse net cash flow if it invests heavily in new fixed assets or if large resources are tied up in working capital. Although less common, poor control over cash flow may sometimes result in cash surpluses. By using the accrual basis of accounting, it does not necessarily follow that the amount of net profit will be matched by a corresponding increase in cash balance.

Net profit is calculated by allowing for outstanding and prepayments (both in respect of income and expenses) at the beginning and end of the accounting period. Furthermore, some items of income and expense charged to the Profit and Loss Account, e.g., profit on sale of fixed assets or depreciation, do not affect the movement of cash. In addition, items regarded as capital, e.g., the purchase of fixed assets do not find a place in the Profit and Loss Account.

In case of X Ltd., the main reason why the bank balance has decreased by ₹ 24,000 (₹ 31,000 – 7,000), whereas the net profit has increased by ₹ 30,000 (₹ 1,00,000 – 70,000), is because net cash outflow from investing activities (₹ 5,08,000) exceeds over the aggregate of net cash inflows from operating activities (₹ 1,94,000) and financing activities (₹ 2,30,000).

Another reason is that X Ltd has invested more of the business funds in working capital, largely because of an increase in the amount owing from debtors and substantial decrease in the amount due to the creditors.

Illustration 22

The Balance Sheet of New Light Ltd. for the years ended 31st March, 2015 and 2016 are as follows:

Balance Sheets of New Light Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	16,00,000	18,80,000
(b) Reserves and Surplus	(2)	8,40,000	11,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 9% Debentures		4,00,000	2,80,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		—	—
(c) Other Current Liabilities		4,80,000	5,20,000
(d) Short-term Provisions	(3)	4,80,000	4,84,000
(e) Unpaid Dividend		—	16,000
TOTAL		38,00,000	42,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(4)	22,80,000	26,40,000
(b) Non-current Investments		4,00,000	3,20,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		—	—
(c) Trade Receivables		—	—
(d) Cash and Cash Equivalents		10,000	10,000
(e) Short-term Loans and Advances		—	—
(f) Other Current Assets		11,10,000	13,10,000
TOTAL		38,00,000	42,80,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	12,00,000	16,00,000
10% Preference Shares	4,00,000	2,80,000
	16,00,000	18,80,000
(2) Reserve and Surplus		
Capital Reserve	—	40,000
General Reserve	6,80,000	8,00,000
Profit and Loss Account	1,60,000	2,60,000
	8,40,000	11,00,000
(3) Short-term Provisions		
Proposed Dividend	1,20,000	1,44,000
Provision for Taxation	3,60,000	3,40,000
	4,80,000	4,84,000
(4) Tangible Assets		
Plant and Machinery	32,00,000	38,00,000
Less: Accumulated Depreciation	9,20,000	11,60,000
	22,80,000	26,40,000

Additional information:

(i) The company sold one Plant and Machinery for ₹ 1,00,000, the cost of which was ₹ 2,00,000 and the depreciation provided on it was ₹ 80,000.

(ii) The company also decided to write off another Plant and Machinery costing ₹ 56,000 on which depreciation amounting to ₹ 40,000 has been provided.

(iii) Depreciation on Plant and Machinery provided ₹ 3,60,000.

(iv) Company sold some investment at a profit of ₹ 40,000, which was credited to capital reserve.

(v) Debentures and preference share capital redeemed at 5% premium.

(vi) Company decided to value stock at cost, whereas previously, the practice was to value stock at cost less 10%. The stock according to books on 31.3.2015 was ₹ 2,16,000. The stock on 31.3.2016 was correctly valued at ₹ 3,00,000.

Prepare Cash Flow Statement by indirect method as per AS—3.

Solution

New Light Ltd..

Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit (Note 1)	76,000	
Add back :		
Transfer to General Reserve	1,20,000	
Proposed Dividend (Note 2)	1,44,000	
Provision for Tax (Note 3)	3,40,000	
Loss on Sale of Fixed Assets (Note 6)	20,000	
Depreciation written-off	3,60,000	
Loss on Disposal of Fixed Assets (Note 7)	16,000	
Premium on Redemption of Preference Shares	6,000	
Premium on Redemption of Debentures	6,000	
Cash Generated from Operations Before Working Capital Changes	10,88,000	
Increase in Other Current Assets (Note 1)	(1,76,000)	
Increase in Other Current Liabilities	40,000	
Cash Generated from Operations	9,52,000	
Income Tax Paid (Note 3)	(3,60,000)	
Net Cash from Operating Activities		5,92,000
Cash Flows from Investing Activities		
Purchase of Fixed Assets (Note 4)	(8,56,000)	
Proceeds from Sale of Fixed Assets	1,00,000	
Proceeds from Sale of Investments (Note 8)	1,20,000	
Net Cash from Investing Activities		(6,36,000)

Cash Flows from Financing Activities		
Proceeds from Issue of Share Capital	4,00,000	
Redemption of Preference Shares including Premium	(1,26,000)	
Redemption of Debentures including Premium	(1,26,000)	
Dividend Paid (₹ 1,20,000 – 16,000)	(1,04,000)	
Net Cash from Financing Activities		44,000
Net Increase in Cash and Cash Equivalents		Nil
Cash and Cash Equivalents at the Beginning of the Period		10,000
Cash and Cash Equivalents at the End of the Period		10,000

Working Notes:

(1) Up to 31.3.2015, company valued stock at cost less 10%. Revised value of stock on 31.3.2015 will be : ₹ 2,16,000 / 90 × 100 = ₹ 2,40,000. For adjusting the value of closing stock on 1.4.2015, the following entry should be passed:

Stock Account	Dr.	₹ 24,000 (₹ 2,40,000 – ₹ 2,16,000)	
To Profit and Loss Account			₹ 24,000

Net Effect will be :

(i) Opening stock will be increased by ₹ 24,000.

(ii) Opening balance of Profit and Loss Account will be increased by ₹ 24,000. Therefore, the revised figure of other current assets will be : ₹ 11,10,000 + ₹ 24,000 = ₹ **11,34,000**.

The revised figure of Profit and Loss Account will be : ₹ 1,60,000 + ₹ 24,000 = ₹ **1,84,000**.

Net Profit for the year 2015-16 = ₹ 2,60,000 – ₹ 1,84,000 = ₹ 76,000.

Increase in the Value of Other Current Assets = ₹ 13,10,000 – ₹ 11,34,000 (calculated above) = ₹ 1,76,000.

(2) It is assumed that dividend proposed for 2015-16 was debited to Profit and Loss Account of ₹ 1,44,000.

(3) It is assumed that tax of ₹ 3,60,000 for the year 2014-15 was paid in 2015-16. Provision for tax for 2015-16 was debited to Profit and Loss Account of ₹ 3,40,000.

Dr. **(4) Fixed Assets Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	32,00,000	?	By Assets Disposal A/c	2,00,000
?	To Bank A/c (Balancing figure)	8,56,000	?	By Assets Discarded A/c	56,000
			31.3.2016	By Balance c/d	38,00,000
		40,56,000			40,56,000

Dr. **(5) Accumulated Depreciation Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Assets Disposal A/c	80,000	1.4.2015	By Balance b/d	9,20,000
	To Assets Discarded A/c	40,000	31.3.2016	By Depreciation A/c	3,60,000
31.3.2016	To Balance c/d	11,60,000			
		12,80,000			12,80,000

Dr. **(6) Assets Disposal Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Fixed Assets A/c	2,00,000	?	By Accumulated Depreciation A/c	80,000
				By Bank A/c	1,00,000
				By Loss on Sale of Fixed Assets A/c (Balancing figure)	20,000
		2,00,000			2,00,000

Dr. **(7) Assets Discarded Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Fixed Assets A/c	56,000	?	By Accumulated Depreciation A/c	40,000
				By Loss on Disposal	16,000
		56,000			56,000

(8) Proceeds from Sale of Investments	₹
Cost of Investment Sold (₹ 4,00,000 – 3,20,000)	80,000
Add: Profit on Sales transferred to Capital Reserve	40,000
	1,20,000

Illustration 23

From the following Balance Sheets and information, prepare Cash Flow Statement of Rayan Ltd. for the year ended 31st March, 2016 :

Balance Sheets of Rayan Ltd. as at 31st March, 2016 and 2015

Particulars	Note No.	31.03.2016 (₹)	31.03.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	6,00,000	7,00,000
(b) Reserves and Surplus	(2)	3,60,000	2,75,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 9% Debentures		2,00,000	—
(4) Current Liabilities :			
(a) Trade Payables	(3)	1,15,000	1,10,000
(b) Other Current Liabilities — Outstanding Expenses		30,000	20,000
(c) Short-term Provisions	(4)	1,85,000	1,20,000
TOTAL		14,90,000	12,25,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(5)	9,15,000	7,00,000
(b) Non-current Investments		50,000	80,000
(2) Current Assets :			
(a) Inventories		95,000	90,000
(b) Trade Receivables	(6)	2,40,000	2,00,000
(c) Cash and Cash Equivalents		65,000	90,000
(d) Voluntary Separation Payments		1,25,000	65,000
TOTAL		14,90,000	12,25,000

Notes to Accounts :

Particulars	31.03.2016 (₹)	31.03.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	6,00,000	5,00,000
10% Redeemable Preference Shares	—	2,00,000
	6,00,000	7,00,000
(2) Reserve and Surplus		
Capital Redemption Reserve	1,00,000	—
Capital Reserve	1,00,000	—
General Reserve	1,00,000	2,50,000
Profit and Loss	60,000	25,000
	3,60,000	2,75,000
(3) Trade Payables		
Sundry Creditors	95,000	80,000
Bills Payable	20,000	30,000
	1,15,000	1,10,000
(4) Short-term Provisions		
Provision for Taxation	95,000	60,000
Proposed Dividend	90,000	60,000
	1,85,000	1,20,000

(5) Tangible Assets		
Land and Building	1,50,000	2,00,000
Plant and Machinery	7,65,000	5,00,000
	9,15,000	7,00,000
(6) Trade Receivables		
Bills Receivables	65,000	70,000
Sundry Debtors	1,75,000	1,30,000
	2,40,000	2,00,000

Additional information:

(i) A piece of land has been sold out for ₹ 1,50,000 (cost — ₹ 1,20,000) and the balance land was revalued. Capital Reserve consisted of profit on sale and profit on revaluation.

(ii) On 1st April, 2015 a plant was sold for ₹ 90,000 (original cost — ₹ 70,000 and WDV — ₹ 50,000) and Debentures worth ₹ 1 lakh was issued at par as part consideration for plant of ₹ 4.5 lakh acquired.

(iii) Part of the investments (cost — ₹ 50,000) was sold for ₹ 70,000.

(iv) Pre-acquisition dividend received ₹ 5,000 was adjusted against cost of investment.

(v) Directors have proposed 15% dividend for the current year.

(vi) Voluntary separation cost of ₹ 50,000 was adjusted against General Reserve.

(vii) Income tax liability for the current year was estimated at ₹ 1,35,000.

(viii) Depreciation @ 15% has been written off from Plant Account but no depreciation has been charged on Land and Building.

Solution

Rayan Limited
Cash Flow Statement for the year ended 31st March, 2016

Particulars	₹	₹
Cash Flows from Operating Activities		
Net Profit Before Tax (Note 1)	2,60,000	
Adjustment For :		
Depreciation (Note 5)	1,35,000	
Profit on Sale of Plant (Note 3)	(40,000)	
Profit on Sale of Investment (Note 4)	(20,000)	
Interest on Debentures	18,000	
Cash Generated from Operations Before Working Capital Changes	3,53,000	
Increase in Inventory	(5,000)	
Decrease in Bills Receivable	5,000	
Increase in Debtors	(45,000)	
Increase in Creditors	15,000	
Decrease in Bills Payable	(10,000)	
Increase in Accrued Liabilities	10,000	
Cash Generated from Operations	3,23,000	
Less: Income Tax Paid	(1,00,000)	
	2,23,000	
Voluntary Separation Payments	(1,10,000)	
Net Cash from Operating Activities		1,13,000
Cash from Investing Activities		
Proceeds from Sale of Land	1,50,000	
Proceeds from Sale of Plant	90,000	
Proceeds from Sale of Investments	70,000	
Purchase of Plant (Note 3)	(3,50,000)	
Purchase of Investments	(25,000)	
Pre-acquisition Dividend Received	5,000	
Net Cash from Investing Activities		(60,000)

Cash from Financing Activities		
Proceeds from Issue of Equity Shares	1,00,000	
Proceeds from Issue of Debentures	1,00,000	
Redemption of Preference Shares	(2,00,000)	
Dividend Paid	(60,000)	
Interest Paid on Debentures	(18,000)	
Net Cash from Financing Activities		(78,000)
Net Decrease in Cash and Cash Equivalents		(25,000)
Cash and Cash Equivalents at the Beginning of the Period		90,000
Cash and Cash Equivalents at the End of the Period		65,000

Working Notes :

(1) Net Profit Before Taxation

Particulars	₹
Balance of Profit on 31.3.2016	60,000
Less: Balance of Profit on 31.3.2015	25,000
	35,000
Add: Provision for Taxation (Note 9)	1,35,000
Add: Proposed Dividend (Note 11)	90,000
	2,60,000

Dr. (2) Land and Building Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	2,00,000	?	By Cash (Sale)	1,50,000
?	To Capital Reserve (Profit on Sale)	30,000	31.3.2016	By Balance c/d	1,50,000
?	To Capital Reserve (Revaluation Profit)	70,000			
		3,00,000			3,00,000

Dr. (3) Plant and Machinery Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	5,00,000	?	By Cash (Sale)	90,000
?	To Profit and Loss A/c (Profit on Sale)	40,000	?	By Depreciation (Note 5)	1,35,000
?	To Debentures A/c	1,00,000	31.3.2016	By Balance c/d	7,65,000
?	To Bank A/c (Purchase — Bal. figure)	3,50,000			
		9,90,000			9,90,000

Dr. (4) Investments Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	80,000		By Cash A/c	70,000
?	To Profit and Loss A/c (Profit on Sale)	20,000		By Dividend (Note)	5,000
?	To Bank A/c (Balancing figure)	25,000	31.3.2016	By Balance c/d	50,000
		1,25,000			1,25,000

(5) Depreciation on plant has been written off @ 15% on plant. After 15% depreciation WDV of Plant and Machinery is ₹ 7,65,000. This WDV represents 85% of the book value of Plant and Machinery before depreciation. Therefore, the book value of Plant and Machinery before depreciation = ₹ 7,65,0000 / 85 ×100 = ₹ **9,00,000**.
Depreciation = 15% of ₹ 9,00,000 = ₹ 1,35,000.
Here, it is to be noted that depreciation has been charged @ 15% (not 15% p.a.). Therefore, the time factor has not been taken into consideration for calculating depreciation.

(6) Post-acquisition dividend is credited to Profit and Loss Account but pre-acquisition dividend is credited to Investment Account and for this, the cost of investment will be reduced.

Dr. (7) Capital Reserve Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.3.2016	To Balance b/d	1,00,000	?	By Land & Building A/c (Profit on Sale)	30,000
			?	By Land and Building A/c (Profit on Revaluation)	70,000
		1,00,000			1,00,000

Dr. (8) General Reserve Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Voluntary Separation Cost A/c	50,000	1.4.2015	By Balance b/d	2,50,000
?	To Capital Redem. Reserve Fund A/c	1,00,000			
31.3.2016	To Balance c/d	1,00,000			
		2,50,000			2,50,000

Dr. (9) Provision for Taxation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Bank A/c (Balancing figure)	1,00,000	1.4.2015	By Balance b/d	60,000
31.3.2016	To Balance c/d	95,000	?	By profit and Loss A/c (Given)	1,35,000
		1,95,000			1,95,000

Dr. (10) Voluntary Separation Payments Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	65,000	?	By General Reserve A/c	50,000
?	To Bank A/c (Balancing figure)	1,10,000	31.3.2016	By Balance c/d	1,25,000
		1,75,000			1,75,000

Dr. (11) Proposed Dividend Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Bank A/c (Balancing figure)	60,000	1.4.2015	By Balance b/d	60,000
31.3.2016	To Balance c/d	90,000	31.3.2016	By Profit and Loss A/c	90,000
		1,50,000			1,50,000

KEY POINTS

- A cash flow statement shows a company's inflows and outflows of cash during a particular accounting period. It shows the impact of operating, financing and investing activities on cash.
- In order to prepare cash flow statement, it is necessary to understand the meaning of different terms which have been used in this standard. The following items have been used in this standard with the meanings specified:
  1. Cash : Cash comprises cash in hand and demand deposits with banks.
  2. Cash Equivalents : Cash equivalents are short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
  3. Cash Flows : Cash flows are inflows and outflows of cash and cash equivalents.
  4. Operating Activities : Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
  5. Investing Activities : Investing activities are the acquisition and disposal of long-term assets not included in cash equivalents/
  6. Financing Activities : Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.
- Interest and dividends are received from investments. Naturally, they should be classified as cash inflows from investment activities (in case of other enterprises).
- The students may follow the following suggested steps for preparation of Cash Flow Statement from given Balance Sheets with some adjustments :
  Step 1 : Set up the requirement format in blank, leaving space to insert details. Use one complete sheet for the statement and another for working notes.
  Step 2 : Study the additional information below the Balance Sheets and mark the related items in the Balance Sheets.
  Step 3 : Go through the Balance Sheet line by line from the top. For many items, you simply have to calculate the difference and enter it to the format as an inflow and outflow of cash. There will be some problem items requiring further work. These are: Sales of fixed assets, Taxation, and Dividends. For these items, you open ledger accounts, insert opening and closing balances and leave it for the time being. You will come back to those workings after you have transferred every items from the Balance Sheet to your answer.
  Step 4 : Complete all the working notes. Transfer all relevant figures to the main statement.
  Step 5 : Complete the main statement.

THEORETICAL QUESTIONS

1. (a) What do you mean by Cash Flow Statement? (b) What are the objectives of Cash Flow Statement?
2. What are the advantages and limitations of Cash Flow Statement?
3. Define : (i) Cash Equivalents; (ii) Operating Activities; (iii) Investing Activities; and (iv) Financing Activities.
4. What are the different methods of calculating 'Net Cash Flows from Operating Activities'? Explain any one of the methods in details.
5. Explain why it is dangerous when analysing Balance Sheets to concentrate attention only on movements of cash balances rather than in working capital.
6. Explain why it is more important to manage long-term profitability than short-term cash flow.

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each statement or answer each question below.

1. Dividends received by financial enterprise is shown in the Cash Flow Statement under :
   A Operating Activities
   B Investing Activities
   C Financing Activities
2. Dividends received by other than financial enterprises is shown in the Cash Flow Statement under :
   A Operating Activities
   B Investing Activities
   C Financing Activities
3. Interest paid by other than financial enterprise is shown in the Cash Flow Statement under :
   A Operating Activities
   B Investing Activities
   C Financing Activities
4. Interest received by other than financial enterprises is shown in the Cash Flow Statement under :
   A Operating Activities
   B Investing Activities
   C Financing Activities
5. How should the revaluation of a fixed asset be treated in a cash flow statement ?
   A it should be included in the cash flow from financing activities;
   B it should be included in the cash flow from investing activities;
   C it should not be included in the cash flow statement.
6. Which of these items could appear in the company's Cash Flow Statement prepared under AS—3 "Cash Flow Statement" ?
   1. Dividend received;
   2. Bonus issue of shares
   3. Dividend paid
   4. Surplus on revaluation of a non-current asset
   5. Loan repayment
   6. Accumulated profit
   A 1, 3 and 5
   B 1, 2, 4 and 5
   C 2, 4 and 6
7. Which of the following items could appear in a company's cash flow statement prepared as per AS—3 (Cash Flow Statement) ?
   1. proposed dividends
   2. rights issue of shares
   3. bonus issue of shares
   4. repayment of loan
   A 1 and 3 **B** 2 and 4 **C** 1 and 4

8. An extract from a cash flow statement prepared by a trainee accountant is shown below :

Cash Flow from Operating Activities

Net Profit before taxation	28,00,000
Adjustment for Depreciation	(9,00,000)
Cash generated from operations before working capital changes	19,00,000
Decrease in inventories	3,00,000
Increase in receivable	(4,00,000)
Increase in payables	(8,00,000)
Cash generated from Operations	10,00,000

Which of the following criticisms of this extract are correct ?

1. Depreciation charges should have been added, not deducted.
2. Decrease in inventories should have been deducted, not added.
3. Increase in receivables should have been added, not deducted.
4. Increase in payables should have been added, not deducted.

A 2 and 4
B 2 and 3
C 1 and 4

9. Which of the following assertions about cash flow statements is / are correct ?

1. A cash flow statement prepared using direct method produces a different figure for operating cash flow from that produced through indirect method.
2. Rights issue of shares do not feature in cash flow statements.
3. A surplus on revaluation of a fixed asset will not appear as an item in a cash flow statement.
4. A profit on the sale of a fixed asset will appear as an item under cash flow from Investing Activities in a cash flow statement.

A 1 and 4
B 2 and 3
C 3 only

10. Part of the process of preparing a company's cash flow statement is the calculation of cash inflow from operating activities.

Which of the following statements about that calculation using indirect method are correct ?

1. Loss on sale of operating fixed assets should be deducted from net profit before taxation.
2. Increase in inventory should be deducted from operating profits.
3. Increase in payables should be added to operating profits.
4. Depreciation charges should be added to net profit before taxation.

A 1, 2 and 3
B 1, 2 and 4
C 2, 3 and 4

11. Which of the following items could appear in a company's cash flow statement ?

1. Surplus on revaluation of fixed assets.
2. Proceeds from issue of debentures.
3. Proposed dividend.
4. Bad debts written off.
5. Dividend received.

A 1, 2 and 5 only
B 2, 3, 4 and 5 only
C 2 and 5 only

12. A cash flow statement prepared in accordance with AS—3 "Cash Flow Statement" opens with the calculation of cash flow from operating activities from the net profit before taxation.

Which of the following lists of items consists only of items that would be ADDED to net profit before taxation in that calcultaion ?

A Decrease in inventories, depreciation, profit on sale of fixed assets.
B Increase in trade payables, decrease in trade receivables, profit on sale of fixed assets.
C Decrease in trade receivables, increase in trade payables, loss on sale of fixed assets.

13. Kabir Limited sold a building at a profit.
How this transaction be treated in the company's cash flow statement ?

	Proceeds of Sale	Profit on Sale
A	Cash inflow under financing activities	Added to profit in calculating cash flow from operating activities
B	Cash inflow under investing activities	Deducted from profit in calculating cash flow from operating activities
C	Cash inflow under investing activities	Added to profit in calculating cash flow from operting activities

14. In the course of preparing a company's cash flow statement, the following figures are to be included in the calculation of net cash from operating activities (all figures in rupees) :
Depreciation charges 9,80,000; Profit on sale of non-current assets 40,000; Increase in inventories 1,30,000; Decrease in receivables 1,00,000; Increase in payables 80,000.
What will be the net effect of these items in the cash flow statement ?
A addition to operating profit 8,90,000;
B subtraction from operating profit 8,90,000
C addition to operating profit 9,90,000.

15. A company purchased a motor vehicle for ₹ 5,00,000. Settlement was made by a payment of ₹ 4,40,000 and the part exchange of one of the company's own vehicles for ₹ 60,000. The vehicle given in part exchange had a written down value of ₹ 1,40,000, but had a re-sale value of ₹ 40,000.
Which amount should be shown in the cash flow statements for the acquisition of the vehicle ?
A ₹ 4,40,000
B ₹ 4,80,000
C ₹ 5,00,000

PRACTICAL QUESTIONS

1. You are given the following particulars relating to the year ended 31st March, 2016 :
(a) Total Sales . . . . . ₹ 4,23,000
(b) Cost of Goods Sold . . . . . ₹ 2,12,000
(c) Expenses for the year . . . . . ₹ 35,000
(d) The position of current assets and liabilities are as follows :

Particulars	31.3.2013 (₹)	31.3.2014 (₹)
Debtors	1,24,000	89,000
Inventories	1,03,000	1,19,000
Prepaid Expenses	21,000	15,000
Creditors	94,000	1,65,000

Ascertain cash from operation for the year 2015-16.

2. Compute Net Cash Flow from Operating Activities from the following :

	₹
(a) Profit and Loss Account balance :	
on 31.03.2015	2,30,000
on 31.03.2016	1,60,000
(b) Other information for the year :	
(i) Bad Debts written off	15,000
(ii) Depreciation provided	30,000
(iii) Dividend on Investment	6,000
(iv) Debenture Interest paid	4,000
(v) Preliminary expenses written-off	2,000
(vi) Income-tax paid	14,000
(vii) Interim dividend	8,000

(viii) Transfer to reserve 40,000
(ix) Old Machinery (WDV — ₹ 18,000) sold for 20,000
(x) Increase in Working Capital 12,000

3. From the following information, calculate Net Cash Flow from Investing Activities :

Particulars	Operating (₹)	Closing (₹)
Machinery (at cost)	8,00,000	8,40,000
Accumulated Depreciation	2,00,000	2,20,000
Patents	5,60,000	3,20,000

Additional information :
(1) During the year, a machine costing ₹ 80,000 with an accumulated depreciation of ₹ 48,000 was sold for ₹ 40,000.
(2) Patents were written-off to the extent of ₹ 80,000 and some patents were sold at a profit of ₹ 40,000.

4. From the information given below relating to Y Ltd., calculate Cash Flows from Operating Activities : ₹
(a) Operating profit before changes in Operating assets 57,500
(b) Debtors (Decrease) 5,000
(c) Stock (Increase) 2,000
(d) Bills Payable (Decrease) 4,500
(e) Creditors (Increase) 3,200
(f) Cash at Bank (Increase) 20,000

5. From the following Balance Sheet of AB Ltd. prepare a Cash Flow Statement for the year ended 31.3.2016:

Balance Sheet of AB Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	2,00,000	2,50,000
(b) Reserves and Surplus	(2)	80,500	90,600
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Bank Loan		70,000	—
(4) Current Liabilities :			
(b) Trade Payables — Sundry Creditors		1.50.000	1.35.200
(d) Short-term Provisions — Provision for Taxation		30.000	35.000
TOTAL		5.30.500	5.10.000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	3,50,000	3,59,000
(ii) Intangible Assets — Goodwill		—	5,000
(2) Current Assets :			
(a) Inventories		1,00,000	74,000
(b) Trade Receivables		80,000	64,200
(c) Cash and Cash Equivalents		500	8,600
TOTAL		5,30,500	5,10,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	2,00,000	2,50,000

(2) Reserve and Surplus		
General Reserve	50,000	60,000
Profit and Loss Account	30,500	30,600
	80,500	90,600
(3) Tangible Assets		
Land and Building	2,00,000	1,90,000
Plant and Machinery	1,50,000	1,69,000
	3,50,000	3,59,000

Additional information —

(a) Dividend of ₹ 23,000 was paid.
(b) Income tax paid during the year ₹ 28,000.
(c) Machinery was purchased during the year ₹ 33,000.
(d) Depreciation written off on building ₹ 10,000; machinery ₹ 14,000.

6. From the following Balance Sheet of Techno India Ltd., prepare a Cash Flow Statement as per AS—3 :

Balance Sheet of Techno India Ltd. as at 31st December, 2015 and 2016

Particulars	Note No.	2015 (₹)	2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		5,50,000	8,50,000
(b) Reserves and Surplus		1,03,000	90,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 9% Debentures		3,00,000	4,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings — Bank Loan		—	30,000
(b) Trade Payables		90,000	1,00,000
(c) Short-term Provisions — Provision for Tax		35,000	40,000
(d) Other Current Liabilities — Outstanding Expenses		30,000	—
TOTAL		11,08,000	15,16,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(1)	4,40,000	6,30,000
(ii) Intangible Assets — Goodwill		80,000	90,000
(b) Non-current Investment		1,20,000	1,50,000
(2) Current Assets :			
(a) Inventories		2,80,000	4,40,000
(b) Trade Receivables — Book Debts		1,25,000	1,75,000
(c) Cash and Cash Equivalents — Cash at Bank		55,000	16,000
(d) Other Current Assets — Prepaid Expenses		8,000	15,000
TOTAL		11,08,000	15,16,000

Notes to Accounts :

Particulars	31.12.2015 (₹)	31.12.2016 (₹)
(1) Fixed Assets		
Tangible Assets — Plant and Machinery	6,20,000	7,00,000
Less: Accumulated Depreciation	1,80,000	70,000
	4,40,000	6,30,000

7. From the following Balance Sheet of JP International, prepare a Cash Flow Statement for the year ended 31st December, 2015 and 2016 :

Balance Sheet of JP International as at 31st December, 2015 and 2016

Particulars	Note No.	2014 (₹ '000)	2015 (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		150	350
Redeemable Preference Share of ₹ 10 each fully paid		100	150
(b) Reserves and Surplus — Profit and Loss Account		—	20
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		150	100
Term Loan		100	50
(4) Current Liabilities :			
(a) Trade Payables — Sundry Creditors		80	100
(b) Short-term Provisions — Proposed Dividend		30	60
Provision for Taxation		20	40
TOTAL		630	870
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		355	620
(ii) Intangible Assets — Goodwill		75	60
(2) Current Assets :			
(a) Inventories		110	70
(b) Trade Receivables — Debtors		120	75
(c) Cash and Cash Equivalents		(60)	25
(d) Other Current Assets — Prepaid Expenses		30	20
TOTAL		630	870

Additional information available on 31.12.2016 :

(a) Accumulated depreciation on Fixed Assets amounted to ₹ 1,60,000 and ₹ 1,85,000 as on 31.12.2015 and 31.12.2016 respectively and a plant costing ₹ 30,000 (25% depreciated) was sold for ₹ 50,000.

(b) Land of ₹ 1,50,000 and Stock of ₹ 40,000 were purchased for a consideration of ₹ 2,00,000, paid for in shares.

(c) Dividend for 2015 was paid along with an interim dividend of 5% on opening Equity Capital.

8. The following are Summarised Balance Sheet of CD Ltd. as on 31st March, 2015 and 2016 :

Balance Sheet of CD Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		4,60,000	4,60,000
(b) Reserves and Surplus :			
Profit and Loss Account Balance		32,000	46,000
General Reserve		1,20,000	1,20,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 8% Debentures		1,80,000	1,40,000

(4) Current Liabilities :			
(b) Trade Payables — Sundry Creditors		2,06,000	1,92,000
(d) Other Current Liabilities — Outstanding Expenses		26,000	24,000
TOTAL		10,24,000	9,82,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		3,00,000	3,00,000
Machinery		24,000	52,000
(b) Non-current Assets		2,20,000	1,48,000
(2) Current Assets :			
(a) Inventories		1,64,000	2,12,000
(b) Trade Receivables — Sundry Debtors		1,34,000	86,000
(c) Cash and Cash Equivalents		1,80,000	1,80,000
(d) Other Current Assets — Prepaid Expenses		2,000	4,000
TOTAL		10,24,000	9,82,000

Notes to Accounts : (₹)

Particulars	31.03.2015	31.03.2016
(1) Fixed Capital		
Tangible Assets — Machinery at Cost	1,04,000	1,40,000
Less: Accumulated Depreciation	80,000	88,000
	24,000	52,000

Additional information :

(i) 10% Dividend was paid during 2015-16.

(ii) Machinery for ₹ 60,000 was purchased and old machinery costing ₹ 24,000 (accumulated depreciation ₹ 12,000) was sold for ₹ 8,000.

(iii) 40,000, 8% Debentures were redeemed by purchase from open market at ₹ 96 for a Debenture of ₹ 100.

(iv) Investment worth ₹ 72,000 were sold at book value.

(v) Bad Debt written-off during the year ₹ 10,000.

Prepare a Statement of Cash Flow as per AS—3 for the year ended 31.03.2016.

9. Following are the Balance Sheet of Young India Ltd. :

Balance Sheet of Young India Ltd. as at 31st March, 2016 and 2015

Particulars	Note No.	31.03.2016 (₹ '000)	31.03.2015 (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		4,300	4,000
(b) Reserves and Surplus — Profit and Loss Account		640	980
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		2,050	2,200
(4) Current Liabilities :			
(b) Trade Payables — Trade Creditors		650	800
(d) Short-term Provisions — Provision for Tax		125	100
TOTAL		7,765	8,080
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land		1,500	1,800
Building	(1)	1,900	2,000
Machinery	(1)	1,700	1,400

(2) Current Assets :			
(b) Inventories		1,400	1,550
(c) Trade Receivables — Debtors		800	650
(d) Cash and Cash Equivalents		400	600
(f) Other Current Assets		65	80
TOTAL		7,765	8,080

Notes to Accounts :

Particulars	31.03.2015 (₹ '000)	31.03.2016 (₹ '000)
(1) Fixed Assets		
Tangible Assets		
(i) Building at Cost	2,500	2,500
Less: Accumulated Depreciation	600	500
	1,900	2,000
(ii) Machinery at Cost	2,000	1,600
Less: Accumulated Depreciation	300	200
	1,700	1,400

Additional information :

(a) Dividend paid during the year ₹ 4,50,000.

(b) Land was sold for cash at a profit of ₹ 50,000.

(c) Machinery costing ₹ 2,00,000 (W.D.V. ₹ 40,000) was sold for ₹ 30,000. Also machinery costing ₹ 6,00,000 was purchased.

(d) Amount transferred to Provision for Taxation during the year ₹ 1,60,000.

Prepare a Cash Flow Statement for the year endd 31.03.2016 as per AS—3.

10. From the following Balance Sheet of R S Enterprise Ltd., prepare Cash Flow Statement as per AS—3 and comment on it.

Balance Sheet of R. S. Enterprise Ltd. as at 31st December, ...

Particulars	Note No.	31.03.2015 (₹ '000)	31.03.2016 (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital :			
Equity Share of ₹ 10 each fully paid		500	1,100
8% Redeemable Preference Share of ₹ 10 each fully paid (Redeemable @ 10% premium)		200	150
(b) Reserves and Surplus		120	135
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 11% Debentures		300	450
(4) Current Liabilities :			
(a) Short-term Borrowings — Bank Loan		300	—
(b) Trade Payables — Sundry Creditors		120	100
(d) Short-term Provisions :			
Provision for Tax		40	40
Proposed Dividend		60	65
TOTAL		1,370	2,040
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		750	1,420
(ii) Intangible Assets		80	55
(b) Non-current Investment		80	60

(2) Current Assets :			
(a) Inventories		180	270
(b) Trade Receivables — Debtors		240	175
(c) Cash and Cash Equivalents		20	45
(d) Other Current Assets — Prepaid Expenses		20	15
TOTAL		1,370	2,040

Other information available on 31.3.2016 :

(i) An old furniture (valued at ₹ 14,000 after 30% depreciation) sold for ₹ 12,000. Accumulated depreciation on fixed assets as on 31.3.2015 and 31.3.2016 were ₹ 1,80,000 and ₹ 2,10,000.

(ii) Land and Building and Stock of another firm of ₹ 5,30,000 and ₹ 60,000 respectively were purchased for a consideration of ₹ 6,00,000 paid for in shares.

(iii) Tax liabilities provided for 2015 was 20% lower than final settlement.

(iv) Debentures were issued at 10% discount and interest on bank overdraft and dividend on investment were ₹ 2,400 and ₹ 5,600 respectively.

11. The Balance Sheet of Fox Ltd at 31st December, 2014 and 2015 are given below:

Balance Sheet of Fox Ltd. as at 31st March, 2014 and 2015

Particulars	Note No.	2014 (₹ '000)	2015 (₹ '000)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	1,000	1,500
(b) Reserves and Surplus	(2)	1,060	2,060
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 12% Debentures		500	1,000
(4) Current Liabilities :			
(b) Trade Payables		200	250
TOTAL		2,760	4,810
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	2,040	3,995
(d) Long-term Loans and Advances			
(e) Other Non-current Assets			
(2) Current Assets :			
(b) Inventories		380	490
(c) Trade Receivables		410	380
(d) Cash and Cash Equivalents		(70)	(55)
TOTAL		2,760	4,810

Notes to Accounts :

Particulars	31.03.2014 (₹ '000)	31.03.2015 (₹ '000)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Share of ₹ 5 each fully paid	1,000	1,500
(2) Reserve and Surplus		
Securities Premium	600	800
Revaluation Reserve	—	400
Accumulated Profits	460	860
	1,060	2,060

(3) Fixed Assets		
Cost of Revaluation	2,740	4,995
Less: Accumulated Depreciation	700	1,000
	2,040	3,995

Notes :

1. **Fixed Assets**
During the year, land carried in the accounts at cost ₹ 8,00,000 was revalued to ₹ 12,00,000. No depreciation had been provided for this land.
Also a fixed assets which had cost ₹ 2,00,000 were sold for ₹ 55,000. Their book value at the time of sale was ₹ 40,000.
2. **Debentures**
₹ 5,00,000, 12% debentures were issued on 1st January, 2015.
3. **Bank Overdraft Interest**
Interest on the bank overdraft for the year was ₹ 8,000.
4. **Share Issue**
1,00,000 equity shares were issued on 30th September, 2015 at a price of ₹ 7 each.
5. **Dividends**
A final dividend of ₹ 60,000 for the year ended 31st December, 2014 was paid on 10th March, 2015. An interim dividend of ₹ 40,000 was paid on 31st October, 2015.

You are required to prepare a Cash Flow Statement for the year ended 31st December, 2015 using indirect method and complying as far as possible with AS-3. Ignore taxation.

12. Usha Limited had the following condensed Trial Balance as at 31.3.2015 :

Debit	₹	Credit	₹
Cash	7,500	Current Liabilities	15,000
Accounts Receivable	30,000	Long-term Notes Payable	25,500
Investments	20,000	Bonds Payable	25,000
Plant	67,500	Capital Stock	15,000
Lanc	40,000	Retained Earnings	24,500
	1,65,000		1,65,000

During 2015-16, the following transactions took place:

(i) A tract of land was purchased for ₹ 7,750 cash.
(ii) Bonds payable in the amount of ₹ 6,000 were retired for cash at face value.
(iii) An additional ₹ 20,000 equity shares were issued at par for cash.
(iv) Dividends totalling ₹ 9,375 were paid.
(v) Net income for 2015-16 was ₹ 28,450 after allowing for depreciation of ₹ 9,500.
(vi) Land was purchased through the issuance of ₹ 22,500 in bonds.
(vii) Usha Ltd.. sold a part of its investments portfolio for ₹ 12,875 cash. The transaction resulted in a gain of ₹ 1,375 for the firm.
(viii) Current liabilities increased to ₹ 18,000 at 31.3.2016.
(ix) Accounts receivable at 31.3.2016 total ₹ 38,000.

Prepare a Cash Flow Statements for 2015-16, with the indirect method as per AS-3 (revised).

[M.Com. (Delhi) — Adapted]

13. From the following information prepare a Cash Flow Statement as per AS-3 :

Balance Sheet of Hero Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	2014 (₹ in Lakhs)	2015 (₹ in Lakhs)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each fully paid		10	15
10% Redeemable Preference Share of ₹ 100 each, ₹ 50 paid up		5	—

(b) Reserves and Surplus :			
Capital Redemption Reserve		—	5
General Reserve		10	7
Profit and Loss Account		3	3
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Other Current Liabilities		10	6
TOTAL		38	36
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant at WDV		15	18
(2) Current Assets :			
(a) Inventories		6	3
(b) Trade Receivables		15	10
(c) Cash and Cash Equivalents		2	5
TOTAL		38	36

Additional information :

(a) During the year the company paid ₹ 2,00,000 as equity dividend and ₹ 50,000 as preference dividend.

(b) The company redeemed the preference shares at par after making a call of ₹ 50 per share to make the shares fully paid.

(c) During the year, one plant, whose book value was ₹ 1,00,000 was sold at a loss of ₹ 20,000 and the company purchased a new plant costing ₹ 6,00,000.

14. From the following information, prepare a Cash Flow Statement for the year ended 31st March, 2016 :

Balance Sheet of Bull Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		2,00,000	2,50,000
(b) Reserves and Surplus — General Reserve		50,000	60,000
Profit and Loss Account		30,500	30,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Bank Loan		70,000	—
(4) Current Liabilities :			
(b) Trade Payables — Sundry Creditors		1,50,000	1,35,200
(d) Short-term Provisions		30,000	35,000
TOTAL		5,30,500	5,10,800
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Land and Building		2,00,000	1,90,000
Plant and Machinery		1,50,000	1,69,000
(ii) Intangible Assets		—	5,000
(2) Current Assets :			
(a) Inventories		1,00,000	74,000
(b) Trade Receivables — Sundry Debtors		80,000	64,200
(c) Cash and Cash Equivalents — Bank		—	8,000
Cash		500	600
TOTAL		5,30,500	5,10,800

Additional information :

(a) Dividend of ₹ 23,000 was paid during the year.
(b) Net profit for the year ₹ 66,100.
(c) Depreciation written-off on building ₹ 10,000 and on machinery ₹ 12,000.
(d) Income tax paid during the year ₹ 33,000.
(e) The following assets of another company were purchased for a consideration of ₹ 50,000 and paid in shares. Assets were : Stock ₹ 20,000; Machinery ₹ 25,000.
(f) Further machinery was purchased for ₹ 8,000 during the year.Loss on sale of machinery ₹ 200 was written off to General Reserve

15. The Balance Sheets of H.P. Ltd.. are given below :

Balance Sheet of H.P. Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital — Equity Share of ₹ 10 each		12,00,000	14,00,000
(b) Reserves and Surplus :			
General Reserve		4,00,000	5,00,000
Profit on Sale of Investment		—	20,000
Profit and Loss Account		1,70,000	3,80,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 7% Debentures		6,00,000	4,00,000
(4) Current Liabilities :			
(a) Trade Payables — Creditors for Expenses		20,000	24,000
Creditors for Goods Supplied		3,20,000	5,00,000
(b) Short-term Provisions : Proposed Dividend		60,000	70,000
Provision for Taxation		1,40,000	1,50,000
TOTAL		29,10,000	34,44,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets at Cost		20,00,000	24,00,000
Less: Accumulated Depreciation		4,00,000	5,00,000
		16,00,000	19,00,000
(b) Non-current Investment at cost		3,60,000	3,60,000
		19,60,000	22,60,000
(2) Current Assets :			
(a) Inventories at Cost		4,00,000	5,40,000
(b) Trade Receivables — Sundry Debtors		4,50,000	4,90,000
Bills Receivable		80,000	1,30,000
(c) Other Current Assets — Prepaid Expenses		20,000	24,000
TOTAL		29,10,000	34,44,000

Additional information :

(i) During the year 2015, fixed assets (valued as ₹ 20,000 depreciation written-off ₹ 60,000) was sold for ₹ 16,000.
(ii) The proposed dividend of last year was paid in 2015.
(iii) During the year 2015, investments costing ₹ 1,60,000 were sold and later in the year investments of the same cost were purchased.
(iv) Debentures were redeemed at a premium of 10% in 2015.
(v) Liability for taxation for 2014 came to ₹ 1,10,000.

You are required to prepare a Cash Flow Statement as per AS-3.

16. The Balance Sheet of Steady Growth Ltd for the year ended 31st March, 2015 and 2016 are as follows:

Balance Sheet of Steady Growth Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital :			
Equity Share of ₹ 10 each fully paid		12,00,000	16,00,000
10% Preference Share of ₹ 10 each fully paid		4,00,000	2,80,000
(b) Reserves and Surplus :			
Capital Reserve		—	40,000
General Reserve		6,80,000	8,00,000
Profit and Loss Account		1,60,000	2,60,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 9% Debentures		4,00,000	2,80,000
(4) Current Liabilities :			
(a) Short-term Provisions :			
Proposed Dividend		1,20,000	1,44,000
Provision for Tax		3,60,000	3,40,000
(b) Other Current Liabilities		4,80,000	5,20,000
(c) Unpaid Dividend		—	16,000
TOTAL		38,00,000	42,80,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets at Cost		32,00,000	38,00,000
Less: Accumulated Depreciation		(9,20,000)	(11,00,000)
		22,80,000	26,40,000
(e) Non-current Investment		4,00,000	3,20,000
(2) Current Assets :			
(a) Other Current Assets		11,10,000	13,10,000
(d) Cash and Cash Equivalents — Cash at Bank		10,000	10,000
TOTAL		38,00,000	42,80,000

Additional information :

(i) The company sold one fixed asset for ₹ 1,00,000, the cost of which was ₹ 2,00,000 and the depreciation of ₹ 80,000 was provided on it.

(ii) Depreciation on fixed assets provided ₹ 3,20,000.

(iii) Company sold some investments at a profit of ₹ 40,000, which was credited to Capital Reserve.

(iv) Debentures and Preference Shares were redeemed at 5% premium.

(v) Company decided to value stock at cost, whereas previously the practice was to value stock at cost less 10%. The stock according to hooks on 31.03.2015 was ₹ 2,16,000. the stock on 31.03.2016 was correctly valued at ₹ 3,00,000.

Prepare Cash Flow Statement as per revised AS-3.

17. Sundarban Ltd. furnishes the following Balance Sheets for the year ended 31st March, 2015 and 31st March, 2016. You are required to prepare a Cash Flow Statement (as per AS–3) for the year ended 31.03.2016 :

Balance Sheet of Sundarban Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		3,00,000	3,30,000
(b) Reserves and Surplus : General Reserve		1,00,000	1,20,000
Capital Reserve		—	15,000
Profit and Loss Account		75,000	95,000
Securities Premium		—	6,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		1,25,000	75,000
(4) Current Liabilities :			
(b) Trade Payables — Sundry Creditors		90,000	80,000
Bills Payable		20,000	35,000
(d) Short-term Provisions : Proposed Dividend		30,000	45,000
Provision for Taxation		28,000	34,000
TOTAL		7,68,000	8,35,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets :			
Plant and Machinery		2,80,000	3,75,000
Furniture and Fixtures		60,000	45,000
(b) Non-current Investment		1,00,000	1,40,000
(2) Current Assets :			
(a) Inventories		80,000	1,25,000
(b) Trade Receivables — Debtors		1,40,000	85,000
Bills Receivables		15,000	18,000
(c) Cash and Cash Equivalents — Cash at Bank		81,000	38,000
(d) Other Current Assets — Unexpired Rent		12,000	9,000
TOTAL		7,68,000	8,35,000

Additional information :

(a) Accumulated Depreciation 31.03.2015 31.03.2016
Plant and Machinery 90,000 1,15,000
Furniture and Fixture 16,000 18,000

(b) Plant costing ₹ 50,000 (accumulated depreciation ₹ 30,000) was sold for ₹ 25,000.

(c) 10% Debentures were redeemed at a premium of 15% and the premium was debited to General Reserve.

(d) Besides, pay-in the proposed dividend in 2015-16, an interim dividend @ 7.5% on share capital at the beginning of this year was also paid.

(e) The income tax was paid ₹ 30,000 in 2015-16.

(f) A furniture purchased on 31st March, 2015 was not up to the requirement. This was sold on 1.4.2015 and the profit was transferred to Capital Reserve. No depreciation was charged on this furniture for the year 2015-16.

.Guide to Answers

Multiple Choice

1. A; 2. B; 3. C; 4. B; 5. C; 6. A; 7. B; 8. C; 9. C; 10. C; 11. C; 12. C; 13. B; 14. C; 15. A.

Practical Questions

1. **Cash from Operation — ₹ 2,72,000.**
2. **Cash Flow from Operating Activities — ₹ 8,000.**
3. **Net Cash Flow from Investing Activities — ₹ 1,20,000.**
4. **Net Cash Flow from Operating Activity — ₹ 59,200.**
5. **Net cash flow from operating activies — ₹ 89,100; Net cash from investing activites — (₹ 38,000); Net cash from financing activities — (₹ 43,000).**
6. **Cash from Operating Activities — ₹ 36,100; Cash from Investing Activities — (₹ 45,000); Cash from Financing Activities (₹ 30,100)**
7. **Net cash flow from operating activities — ₹ 2,92,500; Net cash flow from investing activities — (₹ 1,20,000); Net cash flow from financing activities — (₹ 87,500).**
8. **Net cash flow from Operating Activities — ₹ 64,400; Net cash flow from Investing Activitieis — ₹ 20,000; Net cash flow from Financing Activities — (₹ 84,400).**
9. **Net cash flow from Operating Activities — ₹ 3,20,000; Net cash flow from Investing Activitieis — (₹ 2,20,000); Net cash flow from Financing Activities — (₹ 3,00,000).**
10. **Net cash flow from Operating Activities — ₹ 1,59,800; Net cash flow from Investing Activitieis — (₹ 1,58,000); Net cash flow from Financing Activities — ₹ 23,200.**
11. **Net cash flow from operating activities — ₹ 10,43,000; Net cash flow in investing activities — (₹ 20,00,000); Net cash from financing activities — (₹ 9,72,000).**
12. **Cash Flows from Operating Activities — ₹ 31,575; Net Cash Flows from Investing Activities — 5,125; Net Cash Flows from Financing Activities — ₹ 4,625.**
13. **Net Cash Flows from Operating Activities — ₹ 10,70,000; Net Cash Flows from Investing Activities — 5,20,000; Net Cash Flows from Financing Activities — ₹ 2,50,000.**
14. **Net Cash Flows from Operating Activities — ₹ 1,07,300; Net Cash Flows from Investing Activities — (₹ 6,200); Net Cash Flows from Financing Activities — (₹ 93,000).**
15. **Cash Flows from Operating Activities — ₹ 5,24,000; Cash Flows from Investing Activities — (₹ 4,44,000); Cash Flows from Financing Activities — (₹ 80,000).**
16. **Cash Flow from Operating Activities — ₹ 5,36,000; Cash Flow from Investing Activities — ₹ (5,80,000); Cash Flow from Financing Activities — ₹ 44,000.**
17. **Cash Flow from Operation Activities — ₹ 1,88,000; Cash Flow from Investing Activities — (₹ 1,57,000); Cash Flow from Financing Activities — (₹ 74,000).**

22

Funds Flow Statement

Introduction

According to Jaedicke and Sprouse, accounting is generally concerned with the control of three types of flows, namely, income flows, funds flows and cash flows. The Profit and Loss Account is concerned with the income flows. It is a financial statement of an enterprise's revenues, expenses and profit, which shows profit or loss on business activities. A Balance Sheet is a statement of the assets, liabilities and capital of an enterprise at a particular date, which gives a true and fair view of the state of affairs of the business. The purpose of the Funds Flow Statement is to reconcile between the two Balance Sheets relating to the accounting period by describing the sources from which additional funds were derived and the uses to which these funds were put. The Profit and Loss Account or the Balance Sheet is unable to provide information in this regard. For example, a Profit and Loss Account can show a net profit of ₹ 50,000 but the corresponding Balance Sheet may exhibit a bank overdraft of ₹ 2,00,000. The statement of changes in financial position, i.e., a Funds Flow Statement should enable financial statement users to answer such questions as :

1. Where did the profits go ?
2. Why weren't dividends larger ?
3. How was it possible to distribute dividends in the presence of a loss ?
4. Why are current assets down when there was a profit ?
5. Why is extra financing required ?
6. How was the expansion financed ?
7. Where did the funds from the sale of securities go ?
8. How was the increase in working capital financed ?

Different users of accounting information become increasingly interested in the financing and investing activities of business organisations. In response to this need, a statement of changes in financial position (known as funds flow statement) began to appear in the financial reports.

Meaning of Funds Flow Statement

A Funds Flow Statement which is prepared from two consecutive Balance Sheets (not prepared directly from the accounts) provides an analysis of the sources of additional funds available to the business through its income-generating operations as well as external funds supplied during the accounting period, and an analysis of the manner in which they have been utilised. Funds flow statement may be seen as an essential link between the Profit and Loss Account and the Balance Sheet, and between successive Balance Sheets.

Sources of Funds are :
1. Trading profits;
2. Issue of shares or debentures;
3. Borrowings;
4. Sale of fixed assets;
5. Income from investments; and
6. Decrease in working capital.

Application of Funds are :
1. Trading losses;
2. Purchases of fixed assets;
3. Repayment of borrowings;
4. Payment of tax and dividends; and
5. Increase in working capital.

Meaning of Funds

To most people, the term 'funds' means 'cash'. In accounting, the term 'funds' has a restricted meaning. It is used to refer to 'net working capital', that is, the difference between current assets and current liabilities of a business.

Under the working capital concept of funds, all material transactions that result in a change in the working capital are reported. In using this concept, funds is defined as the amount of increases or decreases in cash, stock, debtors and creditors, bills receivable and payable, and other current items. Under this concept, funds are increased by, for example, selling fixed assets for cash or credit, and issuing shares or debentures for cash or other current assets. Funds are decreased by, for example, buying fixed assets for cash or on credit, redeeming preference shares or debentures, paying taxes or dividends.

Meaning of Flow

The term 'flow' means flow of funds, i.e., change in the amount of working capital. The flow of funds causes an increase or decrease in the amount of working capital. Flow of funds takes place when changes in net working capital (current assets *minus* current liabilities) amount are caused by the changes in non- working capital items. In a business, several transactions take place during an accounting period. Flow of funds takes place when one part of the transaction relates to the working capital and the other part of the transactions relates to the non-working capital category (non-current asset or non-current liability). For example, cash received from debtors and cash paid to creditors are not flow of funds since these transactions change only the current assets and current liabilities. Likewise, conversion of debentures into equity share capital is also not a flow of funds, since it affects only non-current items. Purchase of plant and machinery for cash or credit or issue of shares or debentures for cash are the examples of flow of funds, because they affect working capital as well as non-working capital items.

From the above, it can be comprehended that there will be a flow of funds when a transaction takes place between a :

(a) fixed asset and a current asset; or
(b) current asset and capital/long-term loan; or
(c) fixed asset and a current liability; or
(d) current liability and capital/long-term loan.

Illustrative Example

Indicate which of the following transactions would result in (a) source; (b) use; and (c) neither source nor use of the fund:

(i) Collection from debtors ₹ 5,000;
(ii) Sale of old machinery ₹ 2,000;
(iii) Redemption of debentures ₹ 10,000.

Solution

(i) Collection from debtors ₹ 5,000 is neither source nor use of the funds, since there will be no change in the working capital.

(ii) Sale of old machinery for ₹ 2,000 is a source of funds since the cash balance of the firm will be increased.

(iii) Redemption of debentures ₹ 10,000 is a use of funds since the cash balance of the firm will be decreased.

Illustrative Example

State with reasons whether the following would result in an inflow, outflow or no flow of funds :

(a) Issue of debentures;
(b) Debentures converted as redeemable preference shares;
(c) Amount transferred to provision for taxation;
(d) Tax refund;
(e) Repaid loan on mortgage.

Solution

(a) Issue of debentures is an inflow of funds, since cash balance of the firm will be increased.

(b) Debentures converted as redeemable preference shares will result in no flow of funds, since there will be no change in working capital.

(c) Amount transferred to provision for taxation will result in no flow of funds, since there will be no change in working capital.

(d) Tax refund is an inflow of funds, since cash balance of the firm will be increased.

(e) Repaid loan on mortgage will be an outflow of funds, since cash balance will be decreased.

Objectives of Funds Flow Statement

The main objectives of Funds Flow Statement are :

1. To summarise the financing and investing activities of the entity, including the extent to which the enterprise has generated funds from operation during the period.
2. To complete the disclosure of changes in financial position during the period.

Advantages of Funds Flow Statement

1. The statement makes a clear analysis of the overall business performance for a particular accounting period.
2. The short-term working capital management is not independent of the long-term financial structure with which the business is funded. The sources and applications of funds arise as a matter of course during operations that may also affect long-term financing and investment decisions.
3. It records changes in most assets and liabilities, particularly in the accounts making up the working capital.
4. It reflects decisions involving sources and applications of funds, i.e.,
   (a) applications of funds to invest in assets or to repay liabilities; and
   (b) raising of funds through additional borrowing or by reducing asset investments.
5. The statement provides the basis for a dynamic analysis that focuses on the changes in financial conditions resulting from the decisions made during a particular accounting period.
6. The statement is prepared from a comparison of the opening and closing Balance Sheets of an accounting period and is also linked to the Profit and Loss Account for the same period.

Limitations of Funds Flow Statement

1. It is not a basic financial statement, rather it is a secondary statement. Information already provided in the Profit and Loss Account and Balance Sheet are represented in a different form.
2. It is not a self-explanatory statement. It provides those information which a Balance Sheet fails to explain.
3. It does not take into account non-fund transactions, e.g., issue of debentures other than for cash.

4. The data provided in the statement are historical in nature. In effect, it is not truly futuristic.
5. The statement becomes meaningful only when it is presented along with the basic financial statements, i.e., Profit and Loss Account and the Balance sheet.
6. The statement has the same inherent limitations as the Profit and Loss Account and the Balance Sheet because it is derived from the data contained in these statements.

Distinction Between Balance Sheet and Funds Flow Statement

Sl.No.	Balance Sheet	Sl.No.	Funds Flow Statement
1.	It is a list of assets and liabilities of a business at the end of the accounting period.	1.	It is a statement of changes in assets and liabilities of a business during an accounting period.
2.	It is prepared for a particular day.	2.	It is prepared for a particular accounting period.
3.	It is prepared with the help of ledger balances.	3.	It is prepared with the help of Profit and Loss Account and two consecutive Balance Sheets.
4.	It is prepared to show the financial position of the business.	4.	It is prepared for financing and investing decisions.
5.	It is prepared after the Profit and Loss Account.	5.	It is prepared after the Balance Sheet.
6.	It is necessary to prepare a Balance Sheet in a prescribed form (in case of a limited company).	6.	It is not required to prepare a Funds Flow Statement in a prescribed form.
7.	It is not concerned with flow of funds.	7.	It is mainly concerned with flow of funds.

Distinction Between Income Statement and Funds Flow Statement

Sl.No.	Income Statement	Sl.No.	Funds Flow Statement
1.	It is an account.	1.	It is a statement.
2.	It is prepared from ledger accounts.	2.	It is prepared with the help of the Profit and Loss Account and two consecutive Balance Sheets.
3.	It is not concerned with flow of funds.	3.	It is mainly concerned with flow of funds.
4.	It records only revenue items.	4.	It records only capital items.
5.	It is prepared before the Balance Sheet.	5.	It is prepared after the Balance Sheet.

Distinction Between Net Profit and Funds from Operations

Sl.No.	Net Profit	Sl.No.	Funds from Operations
1.	It is the difference between revenues and expenses.	1.	It is the change in working capital resulting from operations.
2.	It is ascertained from the Profit and Loss Account.	2.	It is ascertained by preparing a statement.
3.	It is not concerned with flow of funds.	3.	It is concerned with flow of funds.
4.	Funds from operations is not the basis for ascertaining net profit.	4.	Net profit is the basis for ascertaining funds from operations.

5.	It is the difference between incomes that should have been received and expenses that should have been paid.	5.	It is the difference between inflow of funds in the form of revenue and outflow of funds in the form of expenses.
6.	It is a part of the Balance Sheet.	6.	It is a part of the sources of funds.

Distinction Between Funds Flow Statement and Schedule of Changes in Working Capital

Sl.No.	Funds Flow Statement	Sl.No.	Schedule of Changes in Working Capital
1.	It shows the sources and applications of funds of the business as a whole.	1.	It shows the changes in individual items of current assets and current liabilities.
2.	It is concerned with current and non-current assets and liabilities.	2.	It is concerned with current assets and liabilities.
3.	It is not a part of the schedule of changes in working capital.	3.	It is a part of the funds flow statement.
4.	It is prepared from the Profit and Loss Account and two consecutive Balance Sheets.	4.	It is prepared from two consecutive Balance Sheets.

Preparation of a Funds Flow Statement

To prepare a funds flow statement we need a company's Balance Sheet at the beginning and at the end of the period for which it is being prepared. The following steps are generally adopted for preparing a funds flow statement :

Step 1 Set up the required format leaving space to insert details.

There is no prescribed format for the funds flow statement. The only important point to be kept in mind is that all important financial events of the period must be exhibited clearly in the statement.

Proforma of a Funds Flow Statement

Funds Flow Statement for the year ended . . .

Sources	₹	Applications	₹
Issue of Share Capital		Redemption of Preference Shares	
Issue of Debentures		Repayment of Loans	
Loans		Redemption of Debentures	
Sales of Fixed Assets		Purchase of Fixed Assets	
Income from Investments		Purchase of Investments	
Funds from Operations		Payment of Dividend	
Decrease in Working Capital		Increase in Working Capital	

An Alternative Proforma

Funds Flow Statement for the year ended . . .

Particulars	₹
Sources	
Issue of Share Capital	
Issue of Debentures	
Loans	
Sales of Fixed Assets	
Income from Investments	
Funds from Operations	
Decrease in Working Capital	
Total	
Applications	
Redemption of Preference Shares	
Repayment of Loans	
Redemption of Debentures	

Purchase of Fixed Assets Purchase of Investments Payment of Dividend Increase in Working Capital	
Total	

Step 2 Prepare a statement / schedule of changes in working capital. This statement shows the net change in working capital. It is computed by subtracting the net working capital at the end of the year from the net working capital at the beginning of the year (see page 7.11 for different steps to be followed).

Since working capital is the difference between ***current assets*** and ***current liabilities***, it should be noted that:

1. An increase in current assets increases working capital. Conversely, a decrease in current assets decreases working capital.
2. An increase in current liabilities decreases working capital. Conversely, a decrease in current liabilities increases working capital.

Current assets are those assets which are held for conversion into cash in the normal course of trading.

Examples of current assets are :

(i) Cash in hand;
(ii) Cash at bank;
(iii) Short-term investments (marketable securities);
(iv) Sundry debtors;
(v) Bills receivable;
(vi) Accrued income;
(vii) Prepaid expenses;
(viii) Stock-in-trade;
(ix) Advance tax;
(x) Short-term loans and advances.

Current liabilities are those liabilities which fall due for payment within one year.

Examples of current liabilities are :

(i) Sundry creditors;
(ii) Bills payable;
(iii) Outstanding expenses;
(iv) Income received in advance;
(v) Bank overdraft.
(vi) Provision for taxation;
(vii) Cash credit;
(viii) Short-term loan.

Step 3 Calculate funds from ***operation***. These are funds provided by the profitable current operations of the business. This is the difference between inflow of funds in the form of revenue and outflow of funds in the form of expenses.

These are the most important and largest sources of funds. These funds are used for repayment of loans, purchase of assets, payment of dividend and taxes, etc.

The net profit disclosed by the Profit and Loss Account may not generate an equal amount of funds to the business. A business making a substantial profit may not have adequate funds at the end of the accounting period. On the contrary, a business may have enough funds at its disposal though it has incurred a substantial loss. The reason for this is that Profit and Loss Account records expenses that should have been paid and records income that should have been received. It takes into account all prepayments and accruals. Moreover, the charging of depreciation or amortisation of intangible or fictitious items do not require any use of funds in the current period. They simply reflect the apportionment of past expenditures. In short, while ascertaining net profit, the Profit and Loss Account does not make any distinction between funds flow and non-funds flow items.

The following are the examples of non-funds flow items appearing in the Profit and Loss Account:
(i) Depreciation;
(ii) Goodwill written off;
(iii) Amortisation of patents;
(iv) Writing off of discount on issue of shares or debentures;
(v) Writing off of preliminary expenses etc.

For calculating funds from operations, any of the following methods can be adopted :

Method 1 Under this method, a Profit and Loss Adjustment Account is prepared in 'T' form. Opening balance of Profit and Loss Account (appearing in the last year's Balance Sheet) is shown on the credit side as ***first*** item. Similarly, closing balance of Profit and Loss Account (appearing in the current year's Balance Sheet) is shown on the debit side as ***last*** item.

Non-funds or non-operating debits are shown on the debit side. Similarly non-funds or non-operating credits are shown on the credit side.

The balancing figure will represent as funds from operations / funds lost in operations. If it is a credit balance then it will be treated as funds from operations. If it is a debit balance then it will be treated as funds lost in operations.

A specimen of Profit and Loss Adjustment Account is given below :

Dr. **Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To Depreciation on Plant		By Balance b/d	
To Goodwill (written-off)		By Profit on Sale of Land	
To Loss on Sale of Machine		By Dividend on Investments	
To Preliminary Expenses (written-off)		By Refund of Tax	
To General Reserve		By Funds from Operations (Balancing figure)	
To Discount on Issue of Shares			
To Balance c/d			

Illustration 1

Calculate 'funds from operations' with the help of the following balances extracted from the books of AB Ltd. :

	31.3.2015	31.3.2016
Profit and Loss Account	3,00,000	2,80,000
General Reserve	1,00,000	1,25,000
Goodwill	50,000	40,000
Provision for Depreciation	20,000	26,000
Preliminary Expenses	15,000	10,000

Solution **Computation of Funds from Operations**

Dr. **Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To General Reserve (Transfer)	25,000	By Balance b/d	3,00,000
To Goodwill (written off)	10,000	By Funds from Operations (Balancing figure)	26,000
To Provision for Depreciation	6,000		
To Preliminary Expenses (Written off)	5,000		
To Balance c/d	2,80,000		
	3,26,000		3,26,000

Method 2 Under this method, funds from operations is calculated on the basis of current year's profit. Opening and closing balances of Profit and Loss Account / Statement of Profit and Loss are not taken into account. The statement showing funds from operations starts with the net profit figure as per the Profit and Loss Account / Statement of Profit and Loss . Thereafter, non-fund or non-operating items are added back and non-fund or non-operating items are subtracted. The resultant figure is the funds from operations. A proforma of the statement for calculation of funds from operation is given below :

Calculation of Funds from Operations

Particulars	₹	₹
Net Profit for the Current Year		*****
Add : Non-funds / non-operating expenses appearing in the Profit and Loss Account / Statement of Profit and Loss		
Depreciation on Plant and Machinery	*****	
Goodwill written off	*****	
Loss on Sale of Machinery	*****	
Preliminary Expenses written off	*****	
Discount on Issue of Shares	*****	
Patents written off	*****	*****
Less : Non-funds / non-operating incomes appearing in the Profit and Loss Account / Statement of Profit and Loss		
Dividend Received on Investments	*****	
Profit on sale of land, etc.	*****	*****
Funds from Operations		*****

Illustration 2

Compute funds from operations from the following Statement of Profit and Loss :

A. Ltd.
Statement of Profit and Loss for the year ended 31st March, 2016

Particulars	Note No.	Figures for the current reporting period (₹)
I. Revenue from Operations		15,00,000
II. Other Incomes		60,000
III. Total Revenue (I + II)		15,60,000
IV. **Expenses :**		
Cost of materials consumed		10,00,000
Change in Inventories of finished goods		50,000
Employee Benefits Expense		3,00,000
Depreciation		70,000
Other Expenses	(1)	24,200
Total Expenses		14,44,200
V. Net Profit for the period (III – IV)		1,15,800

Notes to Accounts :

(1) Other Expenses

	₹
(a) Loss on Sale of Machine	4,000
(b) Discount Allowed	200
(c) Goodwill written-off	20,000
	24,200

Solution

A. Ltd.
Calculation of Funds from Operations

Particulars	₹	₹
Net Profit for the Current Year		1,15,800
Add : Non-funds / non-operating expenses appearing in the Profit and Loss Account / Statement of Profit and Loss		
Depreciation	70,000	
Loss on Sale of Machine	4,000	
Goodwill written off	20,000	94,000
		2,09,800
Less : Non-funds / non-operating incomes appearing in the Profit and Loss Account / Statement of Profit and Loss		
Gain on Sale of Land	60,000	60,000
Funds from Operations		1,49,800

Illustration 3

Calculate funds from operations from the following Statement of Profit and Loss :

X. Ltd.
Statement of Profit and Loss for the year ended 31st March, 2016

Particulars	Note No.	Figures for the current reporting period (₹)
I. Revenue from Operations		5,00,000
II. Other Incomes	(1)	65,000
III. Total Revenue (I + II)		5,65,000
IV. **Expenses :**		
Cost of materials consumed		4,00,000
Changes in Inventories of finished goods		55,000
Employee Benefits Expense — Salary		25,000
Depreciation		4,000
Other Expenses	(2)	24,500
Total Expenses		5,08,500
V. Net Profit for the period (III – IV)		56,500

Notes to Accounts :

(1) Other Incomes

	₹
(a) Profit on Sale of Plant	50,000
(b) Dividend on Investments	15,000
	65,000

(2) Other Expenses

	₹
(a) Loss on Sale of Building	2,000
(b) Goodwill written-off	20,000
(c) Discount Allowed	1,000
(d) Preliminary Expenses written-off	1,500
	24,500

Solution

X Ltd.
Calculation of Funds from Operations

Particulars	₹	₹
Net Profit for the Current Year		56,500
Add : Non-funds / non-operating expenses appearing in the Profit and Loss Account / Statement of Profit and Loss		
Depreciation	4,000	
Loss on Sale of Building	2,000	
Goodwill written off	20,000	
Preliminary Expenses	1,500	27,500
		84,000
Less : Non-funds / non-operating incomes appearing in the Profit and Loss Account / Statement of Profit and Loss		
Gain on Sale of Plant	50,000	
Dividend on Investments	15,000	65,000
Funds from Operations		19,000

Step 4 Study the notes below the Balance Sheets (if any) for additional information and mark the related items in the Balance Sheets. [Exclude all current assets and current liabilities and non-funds items and non-operating items).

Step 5 Calculate inflow/outflow of funds from the above items and enter it to the format.

Step 6 Add both sides of the "Funds Flow Statement".

Some Important Items

Investments

Investments are securities of one company owned by other. These may be held either as a current asset or as a fixed asset. When they are held as current assets for the use of excess cash, they are known as '***Marketable Securities***'. A business may invest money in securities which is temporarily idle, to get some return in cash. But when an investment that is intended to be held for use on a continuing basis in the activities of an enterprise, they are known as '***Trade Investments***'. These investments are of a permanent nature and should be treated as a ***fixed asset.***

Marketable securities are part of the current assets and any change in the balances in between the dates of two Balance Sheets is automatically adjusted through the Statement of Changes in Working Capital. Therefore, no separate treatment is required for marketable securities.

But for trade investments separate treatment is necessary. If the closing balance is more than the opening balance, it represents the fresh acquisition of shares or debentures and, therefore, it is an application of funds. Conversely, if the closing balance is less than the opening balance, it shows that the business has sold a part of its investment and, therefore, it is a source of funds.

Advance Payment of Income Tax

A company is liable to pay tax on its income. Income-tax is payable in the "Assessment year" in respect of the income of the "Previous year". ('Assessment year" means a period of 12 months starting from 1st April and ending on 31st March next.) "Previous year" is the financial year immediately preceding the assessment year.

Example: If the assessment year is 2015-16, the previous year will be 2014-15.

Though the income of the previous year will be assessed in the assessment year, an assessee has to pay tax in advance in the previous year itself against his probable liability to tax in the assessment year immediately following. This advance payment of tax is also known as '***pay as you earn***'. Advance tax shall be payable during a previous year when the amount of such tax payable during that year is ₹. 10,000 or more.

The amount of advance tax is computed in accordance with the provisions of Section 208 to 219 of the Income Tax Act, 1961. When advance tax is paid, the following entry is passed:

Advance Income Tax Account   Dr.
    To Bank Account
(Being advance income tax paid for the previous year . . .)

Advance payment of Income tax is treated as a '***current asset***'. It is shown in the ***Statement of Changes in Working Capital***.

Provision for Taxation

Income tax payable by a company is a charge against the profit of the company. At the end of each accounting year, taxable income is computed by the company as per the provision of the Income Tax Act. After determining the tax liability (based on self-assessment), the company makes a provision for it in the Final Accounts. This liability is provided by passing the following entry :

Profit and Loss Account   Dr.
    To Provision for Income Tax Account
(Being the provision for income tax for the assessment year . . .)

There are two alternative methods of dealing with provision of taxation.

Method 1 In this case provision for taxation is treated as a ***current liability***. It is shown in the "Statement of Changes in Working Capital". The payment of tax made during the current year ***will not*** appear as an application in the "Funds Flow Statement" for the obvious reason that such payments affect two Current Accounts (cash and provision for taxation).

It should be noted that at the time of calculating fund from operation no adjustment is required to be made in the Profit and Loss Adjustment Account.

Method 2 In this case provision for taxation is treated as a ***non-current liability***. It is ***not*** shown in the "Statement of Changes in Working Capital". The payment of tax made during the current year will be shown as an application in the "Funds Flow Statement".

In the work sheet an account is constructed showing opening balance on the ***credit side*** and closing balance on the ***debit side***. Tax paid during the current year is also debited to this account. The balancing figure will be debited to Profit and Loss Adjustment Account to find out '***Funds from Operations***'.

Illustrative Example 1

From the following information, calculate :

(i) the amount to be shown as application in the Funds Flow Statement.

(ii) the amount to be debited to the Profit and Loss Adjustment Account as 'Provision for Income Tax' to find out 'Funds from Operation'.

Particulars	2014 (₹)	2015 (₹)
Provision for Income Tax	30,000	40,000

Income tax of ₹ 25,000 paid during the year 2015 in respect of year 2014.

Solution

(i) ₹ 25,000 will be shown as application in the Funds Flow Statement.

(ii) For calculating the amount to be debited to Profit and Loss Adjustment Account, it is better to prepare a Provision for Income Tax Account as follows :

Dr. **Provision for Income Tax Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Bank A/c	25,000	1.1.2015	By Balance b/d	30,000
31.12.2015	To Balance c/d	40,000	31.12.2015	By Profit & Loss Adjustment A/c	35,000
		65,000			65,000

It is clear from the above Account that ₹ 35,000 will be debited to Profit and Loss Adjustment Account for finding out 'Funds from Operations'.

Proposed Dividend

It is a dividend recommended by the directors of a company for approval by its shareholders at the annual general meeting. Just like provision for taxation, there are two alternative methods of dealing with proposed dividend.

Method 1 In this case proposed dividend is treated as a ***non-current liability***. It is not shown in the "Statement of Changes in Working Capital". The payment of proposed dividend during the current year will be shown as an application in the "Funds Flow Statement". In the work sheet an account is constructed showing opening balance on the ***credit side*** and closing balance on the ***debit side***. Proposed dividend paid during the current year is also debited to this account. The balancing figure will be debited to Profit and Loss Adjustment Account to find out 'Funds from Operations'.

Illustrative Example 2

From the following information, calculate :

(i) the amount to be shown as application in the Funds Flow Statement.

(ii) the amount to be debited to the Profit and Loss Account as 'Proposed Dividend' to find out 'Funds from Operations'.

Particulars	2014 (₹)	2015 (₹)
Proposed Dividend	40,000	45,000

Proposed dividend of the last year was paid during the year 2015.

Solution

(i) ₹ 40,000 will be shown as application in the Funds Flow Statement.

(ii) ₹ 45,000 will be debited to Profit and Loss Adjustment Account to find out 'Funds from Operations'.

Method 2 In this case proposed dividend is treated as a ***current liability***. It is shown in the "Statement of Changes in Working Capital". The payment of proposed dividend during the current year will not appear in the "Funds Flow Statement". ***No adjustment is required to be done in the Profit and Loss Adjustment Account while calculating the funds from operations***.

Interim Dividend

Interim dividend is paid by the company before the closing of the accounting period when the company has earned huge profit as per half-yearly accounts. Interim dividend paid during the year will be shown as an application of fund. For calculating funds from operation it is to be taken into consideration.

Provision for Bad Debts

Provision for bad debts is deducted from sundry debtors and net amount of debtors is shown in the "Statement of Changes in Working Capital". ***Alternatively***, it can be treated as current liability and it can be shown in the "Statement of Changes in Working Capital" under current liability.

When all debtors are good, provision for bad debts will be treated as surplus. The difference between the opening balance of provision and closing balance of provision will be taken into consideration for calculating funds from operation.

Preparation of Statement / Schedule of Changes in Working Capital

Preparation of a Statement / Schedule of Changes in Working Capital involve the following steps :

Step 1 : Draw a proforma.

Proforma of a Statement of Changes in Working Capital :

Statement / Schedule of Changes in Working Capital for the year ended . . .

Particulars	Previous year or Beginning of the year	Current year or End of the year	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)	₹	₹	₹	₹
Cash in hand				
Cash at bank				
Short-term investments (marketable securities)				
Sundry debtors				
Bills receivable				
Accrued income				
Prepaid expenses				
Stock-in-trade				
Advance Tax				
Short-term Loans and Advances				
Current Liabilities (B)				
Sundry creditors				
Bills payable				
Outstanding expenses				
Income received in advance				
Bank overdraft				
Provision for Taxation				
Short-term Loans				
Working Capital (A – B)				
Increase/Decrease in Working Capital				

Step 2 : Identify current assets and enter the names of different current assets in 'particular column' under the heading 'current assets (A)'.

Step 3 : Enter the amount of different current assets in respective columns 'previous year' and 'current year'.

Step 4 : Compare the current year's figure with the previous year's figure. If there is increase in the current asset enter the difference in the 'increase' column. If there is decrease in the current asset, enter the difference in the 'decrease' column.

Step 5 : Identify the current liabilities and enter the names of different current liabilities in 'particular column' under the heading 'current liabilities (B)'.

Step 6 : Enter the amount of different current liabilities in respective columns — 'previous year' and 'current year'.

Step 7 : Compare the current year's figure with the previous year's figure. If there is ***increase*** in the current liability, enter the difference in the '***decrease***' column. If there is decrease in the current liability, enter the difference in the '***increase***' column.

Step 8 : Total the current assets of 'previous year' column.

Step 9 : Total the current liabilities of 'previous year' column.

Step 10 : Calculate the working capital of previous year by taking out the difference of Total Current Assets and Total Current Liabilities, i.e., (A – B).

Step 11 : Total the current assets of 'current year' column.

Step 12 : Total the current liabilities of 'current year' column.

Step 13 : Calculate the working capital of current year by taking out the difference of ***Total Current Assets*** and ***Total Current Liabilities***, i.e., (A – B).

Step 14 : Calculate the difference in working capital as calculated in ***Step 10*** and ***Step 13***. If the working capital of current year (as disclosed in Step 13) is more than the working capital of the previous year (as disclosed in Step 10), enter this amount in the 'previous year column' and in the particulars column write down "***Increase in Working Capital***".
If the working capital of current year (as disclosed in Step 13) is less than the working capital of the previousyear (as disclosed in Step 10) enter this amount in the "***Current year column***" and in the particulars column write down "***Decrease in Working Capital***".

Step 15 : Total all the column, e.g., 'previous year column', 'current year column', 'increase column' and 'decrease column'.

Illustration 4

The Balance Sheets of A Ltd as on 1.1.2015 and 31.12.2015 were as follows :

Balance Sheet of A. Ltd. as at 1st January and 31st December, 2015

Particulars	Note No.	01.01.2015 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		5,00,000	8,00,000
(b) Reserves and Surplus	(1)	1,50,000	2,30,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables	(2)	1,93,000	2,40,000
(c) Other Current Liabilities — Outstanding Expenses		7,000	5,000
(d) Short-term Provisions		—	—
TOTAL		8,50,000	12,75,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	5,80,000	9,20,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,00,000	75,000
(c) Trade Receivables		1,50,000	1,60,000
(d) Cash and Cash Equivalents		20,000	1,20,000
TOTAL		8,50,000	12,75,000

Notes to Accounts :

Particulars	01.01.2015 (₹)	31.12.2015 (₹)
(1) Reserve and Surplus		
(i) General Reserve	50,000	70,000
(ii) Profit and Loss	1,00,000	1,60,000
	1,50,000	2,30,000
(2) Trade Payables		
(i) Sundry Creditors	1,53,000	1,90,000
(ii) Bills Payable	40,000	50,000
	1,93,000	2,40,000
(3) Tangible Assets		
(i) Land and Building	80,000	1,20,000
(ii) Plant and Machinery	5,00,000	8,00,000
	5,80,000	9,20,000

Prepare a Statement of Changes in Working Capital.

Solution

A Ltd

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	1.1.2015 ₹	31.12.2015 ₹	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)				
Inventories	1,00,000	75,000	—	25,000
Sundry Debtors	1,50,000	1,60,000	10,000	—
Cash	20,000	1,20,000	1,00,000	—
	2,70,000	3,55,000		
Current Liabilities (B)				
Sundry Creditors	1,53,000	1,90,000	—	37,000
Bills Payable	40,000	50,000	—	10,000
Outstanding Expenses	7,000	5,000	2,000	—
	2,00,000	2,45,000		
Working Capital (A – B)	70,000	1,10,000	—	—
Increase in Working Capital	40,000	—	—	40,000
	1,10,000	1,10,000	1,12,000	1,12,000

Illustration 5

From the following Balance Sheets of J. P. Ltd as at 31st December, 2014 and 2015 respectively, prepare a Statement of Changes in Working Capital during the year 2015.

Balance Sheet of J. P. Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	40,00,000	40,00,000
(b) Reserves and Surplus	(2)	11,20,000	10,70,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term borrowings		12,80,000	14,30,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors		16,00,000	25,00,000
TOTAL		80,00,000	90,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	32,00,000	34,75,000
(b) Non-current Investments		8,00,000	8,50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		16,00,000	26,00,000
(c) Trade Receivables		20,00,000	18,75,000
(d) Cash and Cash Equivalents		50,000	25,000
(e) Short-term Loans and Advances		3,50,000	1,75,000
TOTAL		80,00,000	90,00,000

Notes to Accounts :

Particulars	01.01.2015 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	30,00,000	32,00,000
10% Redeemable Preference Shares	10,00,000	8,00,000
	40,00,000	40,00,000
(2) Reserve and Surplus		
(i) Securities Premium	3,00,000	3,00,000
(ii) General Reserve	5,00,000	5,00,000
(iii) Profit and Loss Account Balance	3,20,000	2,70,000
	11,20,000	10,70,000
(3) Tangible Assets		
(i) Land at Cost	2,00,000	2,00,000
(ii) Building (Net)	3,00,000	2,75,000
(iii) Plant and Machinery	27,00,000	30,00,000
	32,00,000	34,75,000

Solution

J. P. Ltd

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	31.12.2014 ₹	31.12.2015 ₹	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)				
Stock-in-trade	16,00,000	26,00,000	10,00,000	—
Debtors	20,00,000	18,75,000	—	1,25,000
Short-term Loans and Advances	3,50,000	1,75,000	—	1,75,000
Cash and Bank Balances	50,000	25,000	—	25,000
	40,00,000	46,75,000		
Current Liabilities (B)				
Creditors	16,00,000	25,00,000	—	9,00,000
	16,00,000	25,00,000		
Working Capital (A – B)	24,00,000	21,75,000	—	—
Decrease in Working Capital	—	2,25,000	2,25,000	—
	24,00,000	24,00,000	12,25,000	12,25,000

Illustration 6

From the following Balance Sheets of Beta Ltd., prepare a Statement of Changes in Working Capital.

Balance Sheet of Beta Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	4,50,000	5,00,000
(b) Reserves and Surplus	(2)	1,12,000	1,68,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables	(3)	45,000	63,000
(c) Other Current Liabilities		30,000	36,000
(d) Short-term Provisions — Provision for Taxation		40,000	50,000
TOTAL		6,77,000	8,17,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(4)	2,80,000	3,70,000
(ii) Intangible Assets — Goodwill		1,15,000	90,000
(b) Non-current Investment — Trade Investment		20,000	30,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		77,000	1,09,000
(c) Trade Receivables		1,60,000	2,00,000
(d) Cash and Cash Equivalents		25,000	18,000
TOTAL		6,77,000	8,17,000

Notes to Accounts :

Particulars	01.01.2015 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	3,00,000	4,00,000
15% Redeemable Preference Shares	1,50,000	1,00,000
	4,50,000	5,00,000
(2) Reserve and Surplus		
(i) General Reserve	82,000	1,20,000
(ii) Profit and Loss	30,000	48,000
	1,12,000	1,68,000
(3) Trade Payables		
(i) Sundry Creditors	25,000	47,000
(ii) Bills Payable	20,000	16,000
	45,000	63,000
(4) Tangible Assets		
(i) Building	2,00,000	1,70,000
(ii) Plant	80,000	2,00,000
	2,80,000	3,70,000
(5) Trade Receivables		
(i) Sundry Debtors	1,40,000	1,70,000
(ii) Bills Receivable	20,000	30,000
	1,60,000	2,00,000
(6) Cash and Cash Equivalents		
(i) Cash in Hand	15,000	10,000
(ii) Cash at Bank	10,000	8,000
	25,000	18,000

Solution

Beta Ltd

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	31.12.2014 ₹	31.12.2015 ₹	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)				
Sundry Debtors	1,40,000	1,70,000	30,000	—
Stock-in-Trade	77,000	1,09,000	32,000	—
Bills Receivable	20,000	30,000	10,000	—
Cash in Hand	15,000	10,000	—	5,000
Cash at Bank	10,000	8,000	—	2,000
	2,62,000	3,27,000		
Current Liabilities (B)				
Sundry Creditors	25,000	47,000	—	22,000
Bills Payable	20,000	16,000	4,000	—
Liability for Expenses	30,000	36,000	—	6,000
Provision for Taxation (Note 3)	40,000	50,000	—	10,000
	1,15,000	1,49,000		
Working Capital (A – B)	1,47,000	1,78,000	—	—
Increase in Working Capital	31,000	—	—	31,000
	1,78,000	1,78,000	76,000	76,000

Working Notes :

(1) Trade investment is not a current asset. Therefore, it has not been taken into consideration for calculating changes in working capital.

(2) Preliminary expenses is a fictitious asset. Therefore, it will not be taken into consideration for calculating the changes in working capital.

(3) Provision for taxation has been treated as a current liability. Therefore, it is to be taken into consideration for calculating the changes in working capital.

Illustration 7

The following figures were extracted from the books of Network Pvt Ltd. :	2014 (₹)	2015 (₹)
Accumulated depreciation	40,000	30,000
Fixed assets	1,40,000	1,70,000

Additional information — Depreciation for the year 2015 was ₹ 10,000. A machinery costing ₹ 20,000 had been condemned and scrapped.

Find out the effect of the above information on "Sources/Applications of Funds" of the company during the year 2015.

Solution

Dr. Accumulated Depreciation on Fixed Assets Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
?	To Fixed Assets A/c	20,000	Jan. 1	By Balance b/d	40,000
Dec. 31	To Balance c/d	30,000	Dec. 31	By Profit and Loss A/c	10,000
		50,000			50,000

Dr. Fixed Assets Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan. 1	To Balance b/d	1,40,000	Dec. 31	By Accumulated Depreciation A/c	20,000
?	To Cash A/c (Balancing figure)	50,000	Dec. 31	By Balance c/d	1,70,000
		1,90,000			1,90,000

Effect of the above Transactions

Purchase of fixed assets for ₹ 50,000 will be treated as application of funds.

Illustration 8

X Ltd provides you the following information:	₹
Plant and Machinery (as on 1.1.2015)	8,50,000 (at cost)
Plant and Machinery (as on 31.12.2015)	9,32,000 (at cost)
Accumulated depreciation (as on 1.1.2015)	4,25,000
Accumulated depreciation (as on 31.12.2015)	4,40,000

During the year 2015, t he company provided depreciation amounted to ₹ 80,000 and a machine costing ₹ 1,05,000 was sold at a profit of 20% on book value.

Calculate the amount of Sources and Applications of Funds due to above transactions.

Solution

Dr. Plant and Machinery Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Jan. 1	To Balance b/d	8,50,000	?	By Plant & Machinery Disposal A/c	1,05,000
?	To Bank A/c (Balancing figure)	1,87,000	Dec. 31	By Balance c/d	9,32,000
		10,37,000			10,37,000

Dr. Accumulated Depreciation on Plant and Machinery Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
?	To Plant & Machinery Disposal A/c (Balancing figure)	65,000	Jan. 1	By Balance b/d	4,25,000
Dec. 31	To Balance c/d	4,40,000	Dec. 31	By Profit and Loss Adjustment A/c	80,000
		5,05,000			5,05,000

Dr. **Plant and Machinery Disposal Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
?	To Plant and Machinery A/c	1,05,000	?	By Accumulated Depreciation A/c	65,000
?	To Profit and Loss A/c (Profit)	8,000	?	By Bank A/c (Note 1)	48,000
		1,13,000			1,13,000

Working Note :

(1) Calculation of Sale Proceeds of Machinery

	₹
Cost of machinery sold	1,05,000
Less : Accumulated depreciation	65,000
Book value of machinery sold	40,000
Add: Profit on sale @ 20% of book value	8,000
	48,000

Effect of the above Transactions

(1) Purchase of plant and machinery for ₹ 1,87,500 will be treated as application of funds.
(2) Sale of plant and machinery for ₹ 48,000 will be treated as source of funds.

Illustration 9

From the following summarised financial statement of Anxious Ltd. as at 31.3.2015 and 31.3.2016 prepare :

(a) a Statement of Changes in Working Capital during the year ended 31.3.2016; and
(b) a Statement showing Sources and Applications of Funds during the same period.

Balance Sheet of Anxious Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.3.2015 (₹)	31.3.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		10,00,000	12,00,000
(b) Reserves and Surplus		6,00,000	7,50,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		5,00,000	5,00,000
(4) Current Liabilities :			
(a) Short-term borrowings		—	—
(b) Trade payables — Trade Creditors		9,00,000	10,50,000
(c) Other current liabilities		—	—
(d) Short-term provisions — Proposed Dividend		1,00,000	1,50,000
TOTAL		31,00,000	36,50,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery (Net)		18,00,000	20,50,000
(b) Non-current Investments		2,00,000	2,50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		5,00,000	7,00,000
(c) Trade Receivables — Trade Debtors		5,85,000	6,40,000
(d) Cash and Cash Equivalents		15,000	10,000
TOTAL		31,00,000	36,50,000

During the year ended 31.3.2016 depreciation charged on Plant and Machinery amounted to ₹ 2,00,000. The final dividend for the year 31.3.2015 amounting to ₹ 1,00,000 was paid on 30.6.2015.

Solution

Anxious Ltd.

Statement of Changes in Working Capital for the year ended 31.3.2016

Particulars	31.3.2015 ₹	31.3.2016 ₹	Effect on Working Capital Increase	Effect on Working Capital Decrease
Current Assets (A)				
Inventories	5,00,000	7,00,000	2,00,000	—
Trade Debtors	5,85,000	6,40,000	55,000	—
Cash and Cash Equivalents	15,000	10,000	—	5,000
	11,00,000	13,50,000		
Current Liabilities (B)				
Trade Creditors	9,00,000	10,50,000	—	1,50,000
	9,00,000	10,50,000		
Working Capital (A – B)	2,00,000	3,00,000		
Increase in Working Capital	1,00,000	—	—	1,00,000
	3,00,000	3,00,000	2,55,000	2,55,000

Funds Flow Statement for the year ended 31.3.2016

Sources	₹	Applications	₹
Issue of Shares	2,00,000	Purchase of Plant and Machinery (Note 1)	4,50,000
Funds from Operations (Note 2)	5,00,000	Purchase of Investments	50,000
		Payment of Dividend	1,00,000
		Increase in Working Capital	1,00,000
	7,00,000		7,00,000

Alternatively,

Funds Flow Statement for the year ended 31.3.2016

Particulars	₹
Sources :	
Issue of Shares	2,00,000
Funds from Operations (Note 2)	5,00,000
Total	7,00,000
Applications :	
Purchase of Plant and Machinery (Note 1)	4,50,000
Purchase of Investments	50,000
Payment of Dividend	1,00,000
Increase in Working Capital	1,00,000
Total	7,00,000

Working Notes :

Dr. (1) Plant and Machinery Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.1.2016	To Balance b/d	18,00,000	31.12.2016	By Depreciation A/c	2,00,000
?	To Bank A/c	4,50,000	31.12.2016	By Balance c/d	20,50,000
		22,50,000			22,50,000

Dr. (2) Profit and Loss Adjustment Account Cr.

Particulars	₹	Particulars	₹
To Depreciation on Plant and Machinery	2,00,000	By Balance b/d	1,60,000
To Proposed Dividend	1,50,000	By Funds from Operations (Balancing figure)	5,00,000
To General Reserve	1,00,000		
To Balance c/d	1,50,000		
	6,00,000		6,00,000

Illustration 10

From the following summarised financial statement of Abee Ltd. as at 31st December, 2014 and 31st December, 2015 respectively, prepare :

(i) a Statement of Changes in Working Capital during the calendar year 2015; and

(ii) a Statement showing Sources and Applications of Funds during the same period.

Balance Sheet of Abee Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		15,00,000	20,00,000
(b) Reserves and Surplus	(1)	9,60,300	12,40,640
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Secured		8,60,000	8,60,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		11,79,700	12,39,360
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Proposed Dividend		1,00,000	1,50,000
TOTAL		46,00,000	54,90,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(2)	27,05,000	30,60,400
(b) Non-current Investments		50,000	75,600
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		8,40,430	9,16,340
(c) Trade Receivables		9,85,370	13,68,650
(d) Cash and Cash Equivalents		19,200	69,010
TOTAL		46,00,000	54,90,000

Notes to Accounts :

Particulars	01.01.2015 (₹)	31.12.2015 (₹)
(1) Reserve and Surplus		
(i) Securities Premium	—	50,000
(ii) General Reserve	6,00,000	7,00,000
i(ii) Profit and Loss Account	3,60,300	4,90,640
	9,50,000	12,40,640
(3) Tangible Assets		
(i) Land	2,30,000	2,30,000
(ii) Building (at cost less depreciation)	6,40,000	6,10,000
(iii) Plant and Machinery (at cost less depreciation)	18,35,000	22,20,400
	27,05,000	30,60,400

During 2015, depreciation provided on assets amounted to :

Buildings — ₹ 30,000; and Plant and Machinery — ₹ 2,40,500.

The final dividend for the year 2014 amounted to ₹ 1,00,000 was paid on 8th July, 2015.

Solution

Abee Ltd.

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	31.12.2014 ₹	31.12.2015 ₹	Effect on Working Capital Increase	Effect on Working Capital Decrease
Current Assets (A)				
Inventories	8,40,430	9,16,340	75,910	—
Trade Receivables	9,85,370	13,68,650	3,83,280	—
Cash and Bank Balance	19,200	69,010	49,810	—
	18,45,000	23,54,000		
Current Liabilities (B)				
Sundry Creditors	11,79,700	12,39,360	—	59,660
	11,79,700	12,39,360		
Working Capital (A – B)	6,65,300	11,14,640		
Increase in Working Capital	4,49,340	—	—	4,49,340
	11,14,640	11,14,640	5,09,000	5,09,000

Funds Flow Statement for the year ended 31.12.2015

Sources	₹	Applications	₹
Issue of Shares	5,00,000	Purchase of Plant and Machinery	6,25,900
Receipts of Securities Premium	50,000	Purchase of Investment	25,600
Funds from Operations (Note 3)	6,50,840	Payment of Dividend (2014)	1,00,000
		Increase in Working Capital	4,49,340
	12,00,840		12,00,840

Alternatively,

Funds Flow Statement for the year ended 31.12.2015

Particulars	₹
Sources :	
Issue of Shares	5,00,000
Receipts of Securities Premium	50,000
Funds from Operations (Note 3)	6,50,840
Total	12,00,840
Applications :	
Purchase of Plant and Machinery	6,25,900
Purchase of Investment	25,600
Payment of Dividend (2014)	1,00,000
Increase in Working Capital	4,49,340
Total	12,00,840

Working Notes :

Dr. **(1) Building Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	6,40,000	31.12.2015	By Depreciation A/c	30,000
			31.12.2015	By Balance c/d	6,10,000
		6,40,000			6,40,000

Dr. **(2) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	18,35,000	31.12.2015	By Depreciation A/c	2,40,500
?	To Bank A/c	6,25,900	31.12.2015	By Balance c/d	22,20,400
		24,60,900			24,60,900

Dr. **(3) Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To Depreciation on Building	30,000	By Balance b/d	3,60,300
To Depreciation on Plant and Machinery	2,40,500	By Funds from Operations (Balancing figure)	6,50,840
To Proposed Dividend	1,50,000		
To General Reserve	1,00,000		
To Balance c/d	4,90,640		
	10,11,140		10,11,140

Illustration 11

From the following summarised financial statement of EXWYE Ltd. as at 31st December, 2014 and 31st December, 2015 respectively, prepare :

(i) a Statement of Changes in Working Capital during the year 2015; and

(ii) a Statement showing Sources and Applications of Funds during the same period.

Balance Sheet of EXWYE Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	40,00,000	37,00,000
(b) Reserves and Surplus	(2)	11,20,000	13,00,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term borrowings — Secured Loans		8,80,000	9,70,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		16,00,000	25,00,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Proposed Dividend		4,00,000	5,30,000
TOTAL		80,00,000	90,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	32,00,000	34,75,000
(b) Non-current Investment — Trade Investment		8,00,000	8,50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		16,00,000	26,00,000
(c) Trade Receivables		20,00,000	18,75,000
(d) Cash and Cash Equivalents		50,000	25,000
(e) Short-term loans and advances		3,50,000	1,75,000
(f) Other current assets		—	—
TOTAL		80,00,000	90,00,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	30,00,000	32,00,000
10% Redeemable Preference Shares of ₹ 100 each fully paid	10,00,000	5,00,000
	40,00,000	37,00,000

(2) Reserve and Surplus		
(i) Securities Premium	3,00,000	2,70,000
(ii) Capital Redemption Reserve	—	3,00,000
(iii) General Reserve	5,00,000	3,00,000
iv() Profit and Loss Account	3,20,000	4,30,000
	11,20,000	13,00,000
(4) Tangible Assets		
(i) Land at cost	2,00,000	2,00,000
(ii) Building at cost less depreciation	3,00,000	2,75,000
(iii) Plant and Machinery	27,00,000	30,00,000
	32,00,000	34,75,000

(a) During the year 5,000 redeemable preference shares of ₹ 100 each were redeemed at a premium of 10%. The premium was paid out of Securities Premium Account. For this purpose 20,000 equity shares were issued fully paid for cash at a premium of 10%. The Capital Redemption Reserve was created out of transfers from General Reserve.

(b) Depreciation provided during the year on :
Buildings — ₹ 25,000; and Plant and Machinery — ₹ 3,00,000.

(c) A plant (original cost) ₹ 95,000. Depreciation provided till 31.12.2014 ₹ 78,000 was sold for ₹ 35,000 and the profit on sale transferred to Profit and Loss Account.

(c) Dividend proposed for 2014 was fully paid in 2015.

Solution

EXWYE Ltd.

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	31.12.2014 ₹	31.12.2015 ₹	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)				
Inventories	16,00,000	26.00,000	10,00,000	—
Trade Receivables	20,00,000	18,75,000	—	1,25,000
Loans and Advances	3,50.000	1,75,000	—	1,75,000
Cash and Cash Equivalents	50,000	25,000	—	25,000
	40,00,000	46,75,000		
Current Liabilities (B)				
Trade Payables	16,00,000	25,00,000	—	9,00,000
	16,00,000	25,00,000		
Working Capital (A – B)	24,00,000	21,75,000		
Decrease in Working Capital	—	2,25,000	2,25,000	—
	24,00,000	24,00,000	12,25,000	12.25.000

Funds Flow Statement for the year ended 31.12.2015

Sources	₹	Applications	₹
Issue of Shares including Premium	2,20,000	Purchase of Plant and Machinery (Note 1)	6,17,000
Decrease in Working Capital	2,25,000	Redemption of Preference Shares	5,50,000
Secured Loans taken	90,000	Dividend Paid (2014)	4,00,000
Sale of Plant and Machinery	35,000	Purchase of Investments	50,000
Funds from Operations (Note 2)	10,47,000		
	16,17,000		16,17,000

Alternatively,

Funds Flow Statement for the year ended 31.12.2015

Particulars		₹
Sources :		
Issue of Shares including Premium		2,20,000
Decrease in Working Capital		2,25,000
Secured Loans taken		90,000
Sale of Plant and Machinery		35,000
Funds from Operations (Note 2)		10,47,000
	Total	16,17,000
Applications :		
Purchase of Plant and Machinery (Note 1)		6,17,000
Redemption of Preference Shares		5,50,000
Dividend Paid (2014)		4,00,000
Purchase of Investments		50,000
	Total	16,17,000

Working Notes :

Dr. **(1) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	27,00,000	?	By Depreciation A/c	3,00,000
?	To Profit on Sale of Plant (Note 5)	18,000	?	By Bank A/c (Sale of Plant)	35,000
?	To Bank A/c (Purchase)	6,17,000	31.12.2015	By Balance c/d	30,00,000
		33,35,000			33,35,000

Dr. **(3) Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To Depreciation on Building	25,000	By Balance b/d	3,20,000
To Depreciation on Plant and Machinery	3,00,000	By Plant and Machinery A/c (Profit on Sale)	18,000
To General Reserve	1,00,000	By Funds from Operations (Balancing figure)	10,47,000
To Proposed Dividend	5,30,000		
To Balance c/d	4,30,000		
	13,85,000		13,85,000

Dr. **(3) General Reserve Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Capital Redemption Reserve A/c	3,00,000	1.1.2015	By Balance b/d	5,00,000
31.12.2015	To Balance c/d	3,00,000	31.12.2015	By Profit and Loss A/c	1,00,000
		6,00,000			6,00,000

Dr. **(4) Securities Premium Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Premium on Redemption of Pref. Shares	50,000	1.1.2015	By Balance b/d	3,00,000
31.12.2015	To Balance c/d	2,70,000	?	By Bank A/c	20,000
		3,20,000			3,20,000

Dr. **(5) Profit on Sale of Plant and Machinery** **Cr.**

Particulars	₹
Original Cost	95,000
Less: Depreciation up to 31.12.2014	78,000
Written-down Value	17,000
Less: Sales proceeds	35,000
Profit on Sale of Plant and Machinery	18,000

Illustration 12

From the following Balance Sheets of Beta Ltd., prepare (i) Fund Flow Statement; and (ii) Statement of Changes in Working Capital :

Balance Sheet of Beta Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	4,50,000	5,00,000
(b) Reserves and Surplus	(2)	70,000	1,18,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables	(3)	45,000	63,000
(c) Other Current Liabilities — Outstanding Expenses		30,000	36,000
(d) Short-term Provisions		82,000	1,00,000
TOTAL		6,77,000	8,17,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(5)	2,80,000	3,70,000
(ii) Intangible Assets — Goodwill		1,15,000	90,000
(b) Non-current Investment		20,000	30,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		77,000	1,09,000
(c) Trade Receivables	(6)	1,60,000	2,00,000
(d) Cash and Cash Equivalents	(7)	25,000	18,000
TOTAL		6,77,000	8,17,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	3,00,000	4,00,000
15% Redeemable Preference Shares	1,50,000	1,00,000
	4,50,000	5,00,000
(2) Reserve and Surplus		
(i) Capital Reserve	—	20,000
(ii) General Reserve	40,000	50,000
(iii) Profit and Loss	30,000	48,000
	70,000	98,000
(3) Trade Payables		
(i) Sundry Creditors	25,000	47,000
(ii) Bills Payable	20,000	16,000
	45,000	63,000

(4) Short-term Provisions		
(i) Proposed Dividend	42,000	50,000
(ii) Provision for Taxation	40,000	50,000
	82,000	1,00,000
(5) Tangible Assets		
(i) Building	2,00,000	1,70,000
(ii) Plant	80,000	2,00,000
	2,80,000	3,70,000
(6) Trade Receivables		
(i) Sundry Debtors	1,40,000	1,70,000
(ii) Bills Receivable	20,000	30,000
	1,60,000	2,00,000
(7) Cash and Cash Equivalents		
(i) Cash in Hand	15,000	10,000
(ii) Cash at Bank	10,000	8,000
	25,000	18,000

Additional information :

(a) A building has been sold out in 2015 and the profit on sale has been credited to Capital Reserve.

(b) Plant has been sold for ₹ 10,000. The written-down value of the plant was ₹ 12,000. Depreciation of ₹ 10,000 is charged on Plant Account in 2015.

(c) ₹ 3,000 by way of dividend is received on Trade Investments. This includes ₹ 1,000 from pre-acquisition profit which has been credited to Investment Account.

(d) An interim dividend of ₹ 20,000 has been paid in 2015.

Solution

Beta Limited
Funds Flow Statement for the year ended 31.12.2015

Sources	₹	Applications	₹
Issue of Shares	1,00,000	Purchase of Plant (Note 1)	1,42,000
Dividend Received	3,000	Redemption of Preference Shares	50,000
Sale of Building (₹ 30,000 + 20,000)	50,000	Purchase of Investment (Note 2)	11,000
Sale of Plant	10,000	Payment of Dividend	42,000
Furnds from Operations (Note 3)	1,13,000	Increase in Working Capital	31,000
	2,76,000		2,76,000

Alternatively,

Beta Limited
Funds Flow Statement for the year ended 31.12.2015

Particulars		₹
Sources :		
Issue of Shares		1,00,000
Dividend Received		3,000
Sale of Building (₹ 30,000 + 20,000)		50,000
Sale of Plant		10,000
Furnds from Operations (Note 3)		1,13,000
	Total	2,76,000
Applications :		
Purchase of Plant (Note 1)		1,42,000
Redemption of Preference Shares		50,000
Purchase of Investment (Note 2)		11,000
Payment of Dividend		42,000
Increase in Working Capital		31,000
	Total	2,76,000

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	2014 ₹	2015 ₹	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)				
Sundry Debtors	1,40,000	1,70,000	30,000	—
Inventories	77,000	1,09,000	32,000	—
Bills Receivable	20,000	30,000	10,000	—
Cash in Hand	15,000	10,000	—	5,000
Cash at Bank	10,000	8,000	—	2,000
	2,62,000	3,27,000		
Current Liabilities (B)				
Sundry Creditors	25,000	47,000	—	22,000
Bills Payable	20,000	16,000	4,000	—
Liability for Expenses	30,000	36,000	—	6,000
Provision for Taxation	40,000	50,000	—	10,000
	1,15,000	1,49,000		
Working Capital (A – B)	1,47,000	1,78,000	—	—
Increase in Working Capital	31,000	—	—	31,000
	1,78,000	1,78,000	76,000	76,000

Working Notes :

Dr. **(1) Plant Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	80,000	?	By Bank A/c (Sale)	10,000
?	To Bank A/c (Purchase)	1,42,000	?	By Loss on Sale of Plant	2,000
			?	By Depreciation A/c	10,000
			31.12.2015	By Balance c/d	2,00,000
		2,22,000			2,22,000

Dr. **(2) Investment (Trade) Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/f	20,000	?	By Dividend (Pre-acquisition)	1,000
	To Bank A/c	11,000	31.12.2015	By Balance c/d	30,000
		31,000			31,000

Dr. **(3) Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To Loss on Sale of Plant	2,000	By Balance b/d	30,000
To Goodwill written-off	25,000	By Dividend Received (₹ 3,000 – 1,000)	2,000
To Depreciation	10,000	By Funds from Operations (Balancing figure)	1,13,000
To General Reserve	10,000		
To Proposed Dividend	50,000		
To Balance b/d	48,000		
	1,45,000		1,45,000

Tutorial Note : Any dividend received from pre-acquisition profit is treated as capital receipt and it is adjusted against the cost of investment.

Illustration 13

The Balance Sheet of Symphony Ltd as on 30 June, 2015 and 30 June, 2016 are given below :

Balance Sheet of Symphony Ltd. as at 30th June, 2015 and 2016

Particulars	Note No.	30.06.2015 (₹)	30.06.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	6,00,000	7,00,000
(b) Reserves and Surplus	(2)	2,85,000	4,50,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term borrowings — 8% Debentures		3,00,000	2,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables — Creditors for Goods		1,60,000	2,50,000
(c) Other Current Liabilities — Creditors for Expenses		10,000	12,000
(d) Short-term Provisions	(3)	1,00,000	1,10,000
TOTAL		14,55,000	17,22,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets (Net Block)	(4)	8,00,000	9,50,000
(b) Non-current Investment — at Cost		1,80,000	1,80,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		2,00,000	2,50,000
(c) Trade Receivables	(5)	2,63,000	3,27,000
(d) Cash and Cash Equivalents		10,000	10,000
(e) Short-term loans and advances		—	—
(f) Other current assets — Prepaid Expenses		2,000	5,000
TOTAL		14,55,000	17,22,000

Notes to Accounts :

Particulars	30.06.2015 (₹)	30.06.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	5,00,000	6,50,000
Redeemable Preference Shares	1,00,000	50,000
	6,00,000	7,00,000
(2) Reserve and Surplus		
(i) General Reserve	2,00,000	2,50,000
(ii) Profit on Sale of Investments	—	10,000
(iii) Profit and Loss Account	85,000	1,90,000
	2,85,000	4,50,000
(3) Short-term Provisions		
(i) Proposed Dividend	30,000	35,000
(ii) Provision for Taxation	70,000	75,000
	1,00,000	1,10,000

(4) Tangible Assets			
Plant and Machinery (at Cost)		10,00,000	12,00,000
Less: Provision for Depreciation		2,00,000	2,50,000
	Net Block	8,00,000	9,50,000
(5) Trade Receivables			
(i) Debtors		2,25,000	2,65,000
(ii) Bills Receivable		38,000	62,000
		2,63,000	3,27,000

Other information :

(a) During 2015-16 Plant and Machinery (present book value ₹ 10,000; depreciation written-off ₹ 30,000) was sold for ₹ 8,000.

(b) The dividend proposed in last year was paid in 2015-16.

(c) During 2015-16 investments costing ₹ 80,000 were sold and investments of the same cost were purchased.

(d) Preference Shares were redeemed at 5% premium by issuing new equity shares and debentures were redeemed at 10% premium.

(e) Taxation liability for 2014-15 was settled at ₹ 55,000.

On the basis of the above information, prepare (i) a Statement of Changes in Working Capital; and (b) a Funds Flow Statement of Symphony Ltd. for the year ended 30 June, 2016.

Solution

Symphony Limited

Statement of Changes in Working Capital for the year ended 30.6.2016

Particulars	30.6.2015 ₹	30.6.2016 ₹	Effect on Working Capital Increase	Effect on Working Capital Decrease
Current Assets (A)				
Inventories	2,00,000	2,50,000	50,000	—
Debtors	2,25,000	2,65,000	40,000	—
Bills Receivable	38,000	62,000	24,000	—
Prepaid Expenses	2,000	5,000	3,000	—
Cash	10,000	10,000	—	—
	4,75,000	5,92,000		
Current Liabilities (B)				
Creditors for Expenses	10,000	12,000	—	2,000
Creditors for Goods	1,60,000	2,50,000	—	90,000
Provision for Taxation	70,000	75,000	—	5,000
	2,40,000	3,37,000		
Working Capital (A – B)	2,35,000	2,55,000	—	—
Increase in Working Capital	20,000	—	—	20,000
	2,55,000	2,55,000	1,17,000	1,17,000

Funds Flow Statement for the year ended 30.6.2016

Sources	₹	Applications	₹
Issue of Equity Shares	1,50,000	Purchase of Plant and Machinery	2,40,000
Sale of Investments (₹ 80,000 + 10,000)	90,000	Redemption of Preference Shares	52,500
Sale of Fixed Assets	8,000	Redemption of Debentures	1,10,000
Funds from Operations (Note 4)	2,84,500	Payment of Dividend	30,000
		Purchase of Investments	80,000
		Increase in Working Capital	20,000
	5,32,500		5,32,500

Working Notes :

Dr. **(1) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.7.2015	To Balance b/d	10,00,000	?	By Plant and Machinery Disposal A/c	40,000
?	To Bank A/c (Purchases)	2,40,000	30.6.2016	By Balance c/d	12,00,000
		12,40,000			12,40,000

Dr. (2) Plant and Machinery Disposal Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Plant and Machinery A/c	40,000	?	By Provision for Depreciation A/c	30,000
			?	By Bank A/c	8,000
			?	By Loss on Sale of Plant & Machinery A/c	2,000
		40,000			40,000

Dr. (3) Provision for Depreciation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Plant and Machinery Disposal A/c	30,000	1.7.2015	By Balance b/d	2,00,000
30.6.2016	To Balance c/d	2,50,000	?	By Depreciation A/c	80,000
		2,80,000			2,80,000

Dr. (4) Profit and Loss Adjustment Account Cr.

Particulars	₹	Particulars	₹
To General Reserve	50,000	By Balance b/d	85,000
To Premium on Redemption of Preference Shares	2,500	By Funds from Operations (Balancing figure)	2,84,500
To Premium on Redemption of Debentures	10,000		
To Proposed Dividend	35,000		
To Depreciation	80,000		
To Loss on Sale of Plant and Machinery	2,000		
To Balance c/d	1,90,000		
	3,69,500		3,69,500

Illustration 14

The following Balance Sheets were extracted from the books of account of Jaypee Ltd. at 31.3.2015 and 31.3.2016 respectively:

Balance Sheet of Jaypee Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.3.2015 (₹)	31.3.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	3,00,000	2,75,000
(b) Reserves and Surplus	(2)	49,750	90,300
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term borrowings	(3)	75,000	87.500
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		46.500	61,500
(c) Other Current Liabilities		—	—
(d) Short-term Provisions	(4)	41.000	53,500
TOTAL		5.12.250	5,67,800
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(5)	3,19,000	3,07,500
(ii) Intangible Assets — Goodwill		12,500	10,000
(b) Non-current Investment	(6)	72,500	67,500
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		27,700	58,150
(c) Trade Receivables		66,000	92,500
(d) Cash and Cash Equivalents	(7)	14,550	32,150
TOTAL		5,12,250	5,67,800

Notes to Accounts :

Particulars		31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital			
Issued, Subscribed and Paid-up Capital :			
Equity Shares of ₹ 10 each		1,50,000	2,00,000
Redeemable Preference Shares		1,50,000	75,000
		3,00,000	2,75,000
(2) Reserve and Surplus			
(i) Capital Redemption Reserve		—	25,000
(i) Securities Premium		—	5,000
(iii) General Reserve		30,000	30,000
(iv) Profit and Loss		19,750	30,300
		49,750	90,300
(3) Long-term Borrowings			
(i) 10% 'A' Mortgage Debentures		25,000	12,500
(ii) 8% 'B' Mortgage Debentures		50,000	75,000
		75,000	87,500
(4) Short-term Provisions			
(i) Provision for Taxation		26,000	33,500
(ii) Proposed Dividend		15,000	20,000
		41,000	53,500
(5) Tangible Assets			
(i) Land and Building at Cost		1,50,000	1,75,000
Less: Provision for Depreciation		30,000	37,500
	Total (A)	1,20,000	1,37,500
(ii) Plant and Machinery at Cost		2,78,000	2,70,000
Less: Provision for Depreciation		79,000	1,00,000
	Total (B)	1,99,000	1,70,000
	Total Tangible Assets (A + B)	3,19,000	3,07,500
(6) Non-current Investments			
(i) Investments in Subsidiary Co.		35,000	45,000
(ii) Long-term Investments		37,500	22,500
		72,500	67,500
(7) Cash and Cash Equivalents			
(i) Cash in Hand		550	1,150
(ii) Cash at Bank		14,000	31,000
		14,550	32,150

Additional information :

(a) Preference Shares were redeemed partly out of fresh issue of Equity Shares and partly out of funds available for dividends and premium at 5% payable on redemption was charged to Profit and Loss Account.

(b) 50% of 10% 'A' Debentures were redeemed at a discount of 10%. Amount of discount credited to Profit and Loss Account.

(c) Part of Plant and Machinery costing ₹ 12,500 against provision of depreciation of ₹ 6,500 was sold at ₹ 9,500 and profit thereon credited to Profit and Loss Account.

(d) In addition to proposed dividend of earlier years an interim dividend at 10% was also paid during the year.

(e) ₹ 22,500 paid during the year by way of taxation for earlier years.

You are required to prepare :

(ia a Schedule of Changes in Working Capital; and

(b) a Funds Flow Statement.

Solution

Jaypee Ltd.
Schedule of Changes in Working Capital for the year ended 31.3.2016

Particulars	31.3.2015 ₹	31.3.2016 ₹	Effect on Working Capital Increase	Effect on Working Capital Decrease
Current Assets (A)				
Trade Receivables	66,000	92,500	26,500	—
Inventories	27,700	58,150	30,450	—
Cash in Hand	550	1,150	600	—
Cash at Bank	14,000	31,000	17,000	—
	1,08,250	1,82,800		
Current Liabilities (B)				
Trade Payables	46,500	61,500	—	15,000
Provision for Taxation*	26,000	33,500	—	7,500
	72,500	95,000		
Working Capital (A – B)	35,750	87,800	—	—
Increase in Working Capital	52,050	—	—	52,050
	87,800	87,800	74,550	74,550

*Provision for taxation has been treated as current liabilities. Therefore, any payment of tax is to be ignored in 'Funds Flow Statement'.

Funds Flow Statement for the year ended 31.3.2016

Sources	₹	Applications	₹
Issue of Shares	55,000	Purchase of Investment in Subsidiary	10,000
Issue of Debentures	25,000	Purchase of Plant (Note 1)	4,500
Sale of Long-term Investments	15,000	Payment of Dividend (2014-15)	15,000
Sale of Plant	9,500	Payment of Interim Dividend	15,000
Funds from Operations (Note 9)	1,07,050	Redemption of Preference Shares (Note 7)	78,750
		Redemption of Debentures (Note 8)	11,250
		Purchase of Land and Building	25,000
		Increase in Working Capital	52,050
	2,11,550		2,11,550

Working Notes :

(1) Plant and Machinery Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
1.4.2015	To Balance b/d	2,78,000	?	By Plant Disposal A/c	12,500
	To Bank A/c (Purchase)	4,500	31.3.2016	By Balance c/d	2,70,000
		2,82,500			2,82,500

(2) Plant Disposal Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
?	To Plant and Machinery A/c	12,500	?	By Provision for Depreciation A/c	6,500
?	To Profit on Sale of Plant A/c	3,500	?	By Bank Ac (Sale)	9,500
		16,000			16,000

(3) Provision for Depreciation on Plant and Machinery Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
?	To Plant Disposal A/c	6,500	1.4.2015	By Balance b/d	79,000
31.3.2015	To Balance c/d	1,00,000	31.3.2016	By Profit and Loss A/c (Depre. for the year)	27,500
		1,06,500			1,06,500

(4) Land and Building Account

Dr. Date	Particulars	₹	Date	Particulars	Cr. ₹
1.4.2015	To Balance b/d	1,50,000	31.3.2015	By Balance c/d	1,75,000
?	To Bank A/c	25,000			
		1,75,000			1,75,000

Dr. (5) Provision for Depreciation on Land and Building Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.3.2016	To Balance c/d	37,500	1.4.2015	By Balance b/d	30,000
			31.3.2016	By Profit and Loss A/c (Depre. for the year)	7,500
		37,500			37,500

(6) Amount to be transferred to Capital Redemption Reserve Account

	₹
Face value of Preference Shares redeemed	75,000
Less: Proceeds from New Shares (excluding premium)	50,000
Amount to be transferred to Capital Redemption Reserve	**25,000**

(7) Amount to be paid to Preference Shareholders

Face value of Shares	75,000
Add: 5% Premium	3,750
	78,750

(8) Amount to be paid to Debentureholders

Face value of Debentures	12,500
Less: Discount 10%	1,250
	11,250

Dr. (9) Profit and Loss Adjustment Account Cr.

Particulars	₹	Particulars	₹
To Provision for Depreciation on :		By Balance b/d	25,750
Plant and Machinery (Note 3)	27,500	By Profit on Sale of Plant (Note 2)	3,500
Land and Building (Note 5)	7,500	By Discount on Redemption of Debentures (Note 8)	1,250
To Premium on Redemption of Preference Shares (Note 7)	3,750	By Funds from Operations (Balancing figure)	1,07,050
To Interim Dividend	15,000		
To Proposed Dividend	20,000		
To Capital Redemption Reserve (Note 6)	25,000		
To Preliminary Expenses (written-off)	1,500		
To Goodwill (written-off)	2,500		
To Balance c/d	34,800		
	1,37,550		1,37,550

Illustration 15

From the following summarised Balance Sheets of Anand Ltd. as at 31st March, 2015 and 31st March, 2016 respectively, you are required to prepare :

(a) Statement of Changes in Working Capital; and

(b) Statement of Sources and Application of Funds.

All workings should form part of your answer.

Balance Sheet of Anand Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	1,75,000	2,00,000
(b) Reserves and Surplus	(2)	1,15,350	1,12,700
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(a) Long-term borrowings		—	40,000

(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		84,450	75,550
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Proposed Dividend on Equity Shares		12,000	24,000
TOTAL		3,86,800	4,52,250
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	1,50,050	1,55,250
(b) Non-current Investment — Trade Investment		61,000	76,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		98,000	1,04,000
(c) Trade Receivables		88,000	85,000
(d) Cash and Cash Equivalents		(10,250)	32,000
TOTAL		3,86,800	4,52,250

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	75,000	1,20,000
10% Redeemable Preference Shares Capital	1,00,000	80,000
	1,75,000	2,00,000
(2) Reserve and Surplus		
(i) Reserve for Replacement of Machinery	15,000	10,000
(ii) Profit and Loss Account	1,00,350	1,02,700
	1,15,350	1,12,700
(3) Fixed Assets		
Tangible Assets at Cost	2,40,070	2,53,730
Less: Accumulated Depreciation	90,020	98,480
	1,50,050	1,55,250

Additional information :

(1) During the year, additional equity capital was issued to the extent of ₹ 25,000 by way of bonus shares fully paid up.

(2) Final dividend on preference shares and an interim dividend of ₹ 4,000 on equity shares were paid on 31st March, 2016.

(3) Proposed dividends for the year ended 31st March, 2015 were paid in October, 2015.

(4) Movement in reserve for replacement of Machinery Account represents transfer to Profit and Loss Account.

(5) During the year, one item of plant was revalued upward by ₹ 3,000 and credit for this was taken in the Profit and Loss Account.

(6) ₹ 1,700 being expenditure on Plant and Machinery for the year ended 31st March, 2015 wrongly debited to Sundry Debtors then, was corrected in the next year.

(7) Fixed assets costing ₹ 6,000 (accumulated depreciation ₹ 4,800) were sold for ₹ 250. Loss arising therefrom was written off.

(8) Preference shares redeemed in the year June 2015 were out of a fresh issue of equity shares. Premium paid on redemption was 10%.

Solution

Anand Ltd.

Statement of Changes in Working Capital for the year ended 31.12.2016

Particulars	31.3.2015 ₹	31.3.2016 ₹	Effect on Working Capital	
			Increase	Decrease
Current Assets (A)				
Inventories	98,000	1,04,000	6,000	—
Trade Receivables (Note 3)	86,300	85,000	—	1,300
Bank	(10,250)	32,000	42,250	—
	1,74,050	2,21,000		
Current Liabilities (B)				
Trade Creditors	84,450	75,550	8,900	—
	84,450	75,550		
Working Capital (A – B)	89,600	1,45,450	—	—
Increase in Working Capital	55,850	—	—	55,850
	1,45,450	1,45,450	57,150	57,150

Funds Flow Statement for the year ended 31.3.2016

Sources	₹	Applications	₹
Issue of Equity Shares (Note 5)	20,000	Purchase of Fixed Assets	14,960
Long-term Loan Taken	40,000	Redemption of Preference Shares	22,000
Sale of Fixed Assets	250	Dividend to Equity Shareholder (2014-15)	12,000
Funds from Operations (Note 6)	71,560	Interim Dividend to Equity Shareholders (2015-16)	4,000
		Preference Dividend Paid (2015-16)	8,000
		Purchase of Investments	15,000
		Increase in Working Capital	55,850
	1,31,810		1,31,810

Working Notes :

Dr. (1) Fixed Assets Account Cr.

Date	Particulars	₹	Date	Particulars	₹
1.4.2015	To Balance b/d	2,40,070	?	By Fixed Assets Disposal A/c	6,000
?	To Trade Debtors A/c (Rectification)	1,700	31.3.2016	By Balance c/d	2,53,730
?	To Profit and Loss A/c (Revaluation)	3,000			
?	To Bank A/c (Purchases)	14,960			
		2,59,730			2,59,730

Dr. (2) Fixed Assets Disposal Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Fixed Assets A/c	6,000	?	By Provision for Depreciation A/c	4,800
			?	By Bank A/c (Sale)	250
			?	By Loss on Sale of Fixed Assets	950
		6,000			6,000

(3) Balance of trade debtors as on 31st March, 2015 = ₹ 88,000. After rectification of errors of ₹ 1,700, the final balance will be: ₹ 86,300 (88,000 – 1,700).

Dr. (4) Provision for Depreciation Account Cr.

Date	Particulars	₹	Date	Particulars	₹
?	To Fixed Assets Disposal A/c	4,800	1.4.2015	By Balance b/d	90,020
31.3.2016	To Balance c/d	98,480	?	By Depreciation A/c (Current year's depreciation)	13.260
		1,03,280			1,03,280

Dr. (5) Equity Share Capital Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.3.2016	To Balance c/d	1,20,000	1.4.2015	By Balance b/d	75,000
			?	By Profit and Loss A/c (Bonus shares)	25,000
			?	By Bank A/c (Fresh issue of shares for cash)	20,000
		1,20,000			1,20,000

Dr. (9) Profit and Loss Adjustment Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Capital (Bonus Shares)	25,000	By Balance b/d	1,00,350
To Depreciation (Note 4)	13,260	By Reserve for Replacement of Machinery	5,000
To Premium on Redemption of Preference Shares	2,000	By Revaluation Profit on Fixed Assets	3,000
To Dividends :		By Funds from Operations (Balancing figure)	71,560
Interim equity (2015-16)	4,000		
Proposed on equity (2015-16)	24,000		
Preferece Dividend (2015-16)	8,000		
To Loss on Sale of Fixed Assets	950		
To Balance c/d	1,02,700		
	1,79,910		1,79,910

Illustration 16

The Balance Sheets of AB Ltd. as on 31st December, 2014 and 2015 are as under :

Balance Sheet of AB Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	3,00,000	3,50,000
(b) Reserves and Surplus	(2)	38,000	82,000
(2) Share Application Money Pending Allotment :			
(3) Non-current Liabilities :			
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		44,000	65,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Provision for Taxation	(3)	55,000	65,000
TOTAL		4,37,000	5,62,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(4)	1,90,000	2,66,000
(ii) Intangible Assets — Goodwill		60,000	47,000
(b) Non-current Investment — Trade Investment		10,000	35,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories — Stock-in-Trade		85,000	78,000
(c) Trade Receivables		75,000	1,08,000
(d) Cash and Cash Equivalents	(5)	17,000	28,000
TOTAL		4,37,000	5,62,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	1,50,000	2,50,000
8% Redeemable Preference Shares	1,50,000	1,00,000
	3,00,000	3,50,000

(2) Reserve and Surplus		
(i) General Reserve	20,000	30,000
(ii) Capital Reserve	—	25,000
(iii) Profit and Loss Account	18,000	27,000
	38,000	82,000
(3) Short-term Provisions		
(i) Provision for Taxation	28,000	32,000
(ii) Proposed Dividend	27,000	33,000
	55,000	65,000
(4) Tangible Assets		
(i) Land and Building	1,00,000	75,000
(ii) Plant and Machinery	90,000	1,91,000
Net Block	1,90,000	2,66,000
(5) Cash and Cash Equivalents		
(i) Cash at Bank	10,000	22,000
(ii) Cash in Hand	7,000	6,000
	17,000	28,000

The following further particulars are given :

(i) In 2015 ₹ 18,000 depreciation has been written off Plant and Machinery and no depreciation has been charged on Land and Building.

(ii) A piece of land has been sold out and the balance has been revalued, profit on such sale and revaluation being transferred to Capital Reserve. There is no other entry in Capital Reserve Account.

(iii) A plant was sold for ₹ 12,000 (W.D.V. — ₹ 15,000).

(iv) Dividend received amounted to ₹ 2,100 which included pre-acquisition dividend of ₹ 600.

(v) An interim dividend of ₹ 10,000 has been paid in 2015.

You are required to prepare :

(i) Statement of Source and Application of Funds; and

(ii) Statement of Changes in Working Capital for the year 2015.

All workings should form part of your answer.

Solution

AB Ltd.

Statement of Sources and Application of Funds for the year ended . . .

Sources	₹	Applications	₹
Issue of Equity Shares	1,00,000	Purchases of Plant	1,34,000
Dividend Received	2,100	Redemption of Preference Shares	50,000
Sale of Land	50,000	Dividend Paid for 2014	27,000
Sale of Plant	12,000	Interim Dividend	10,000
Funds from Operations (Note 4)	94,500	Purchases of Investments	25,600
		Increase in Working Capital	12,000
	2,58,600		2,58,600

Statement of Changes in Working Capital for the year ended 31.12.2015

Particulars	2014 ₹	2015 ₹	Effect on Working Capital: Increase	Effect on Working Capital: Decrease
Current Assets (A)				
Stock-in-Trade	85,000	78,000	—	7,000
Trade Receivables	75,000	1,08,000	33,000	—
Cash at Bank	10,000	22,000	12,000	—
Cash in Hand	7,000	6,000	—	1,000
	1,77,000	2,14,000		

Current Liabilities (B)				
Trade Payables	44,000	65,000	—	21,000
Provision for Taxation	28,000	32,000	—	4,000
	72,000	97,000		
Working Capital (A – B)	1,05,000	1,17,000		
Increase in Working Capital	12,000	—	—	12,000
	1,17,000	1,17,000	45,000	45,000

Working Notes :

Dr. **(1) Plant and Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	90,000	?	By Depreciation A/c	18,000
?	To Bank A/c (Purchase)	1,34,000	?	By Bank (Sale) A/c	12,000
			?	By Loss on Sale of Plant A/c	3,000
			31.12.2015	By Balance c/d	1,91,000
		2,24,000			2,24,000

Dr. **(2) Land and Building Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	1,00,000	?	By Bank (Sale)	50,000
?	To Capital Reserve (Profit on sale and revaluation)	25,000	31.12.2015	By Balance c/d	75,000
		1,25,000			1,25,000

Dr. **(3) Investment Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.1.2015	To Balance b/d	10,000	?	By Dividend Received A/c (Note 5)	600
?	To Bank A/c (Purchases)	25,600	31.12.2015	By Balance c/d	35,000
		35,600			35,600

Dr. **(4) Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To Depreciation	18,000	By Balance b/d	18,000
To Loss on Sale of Plant	3,000	By Dividend Received (Note 5)	1,500
To Goodwill Written-off	13,000	By Funds from Operations (Balancing figure)	94,500
To General Reserve	10,000		
To Proposed Dividend (Note 6)	33,000		
To Interim Dividend	10,000		
To Balance c/d	27,000		
	1,14,000		1,14,000

(5) Total dividend received ₹ 2,100. Out of which ₹ 600 is related to pre-acquisition profit. Dividend from pre-acquisition profit will be credited to Investment Account and the balance dividend ₹ 1,500 (₹ 2,100 – ₹ 600) will be credited to Profit and Loss Account.

(6) It has been assumed that proposed dividend include preference dividend also.

Alternative Treatment :

(i) Tax paid may be shown as an application with consequential deletion of this item from 'Statement of Changes in Working Capital'.

(ii) Proposed dividend may also be considered as a current liability in the 'Statement of Changes in Working Capital' with consequential changes in Profit and Loss Adjustment Account.

Illustration 17

From the following Balance Sheets of Sneha Ltd as on 31.3.2014 and 31.3.2015 prepare a Statement of Sources and Application of Fund and a Schedule of Changes in Working Capital for the year ending 31.3.2015.

Balance Sheet of Sneha Ltd. as at 31st March, 2014 and 2015

Particulars	Note No.	31.3.2014 (₹)	31.3.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital		13,00,000	16,90,000
(b) Reserves and Surplus — Profit and Loss Account		4,58,250	8,48,500
(2) Share Application Money Pending Allotment		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		16,25,000	13,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables	(1)	9,42,500	11,70,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions	(2)	2,60,000	10,17,250
TOTAL		45,85,750	60,25,750
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	27,88,500	32,76,000
(ii) Intangible Assets — Goodwill		65,000	42,500
(b) Non-current Investments		5,07,000	3,93,250
(c) Other non-current assets — Prepaid Expenses		42,250	52,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		5,07,000	7,99,500
(c) Trade Receivables		4,16,000	11,70,000
(d) Cash and Cash Equivalents		2,60,000	2,92,500
TOTAL		45,85,750	60,25,750

Notes to Accounts :

Particulars	31.3.2014 (₹)	31.3.2015 (₹)
(1) Trade Payables		
Trade Creditors	9,00,000	10,00,000
Bills Payable	42,500	1,70,000
	9,42,500	11,70,000
(3) Short-term Provisions		
Provision for Taxation	2,60,000	9,75,000
Dividend Payable	—	42,250
	2,60,000	10,17,250
(4) Tangible Assets		
Building	11,70,000	11,37,500
Machinery	16,18,000	21,38,500
	27,88,000	32,76,000

The following additional information is given

(i)

	Building (₹)	Machinery (₹)
Accumulated depreciation 31.3.2014	4,87,500	15,92,500
Accumulated depreciation 31.3.2015	5,20,000	15,66,500
Depreciation for 2014-15	32,500	1,36,500

(ii) Profit and Loss Account for 2014-15 are as follows:

	₹
Balance as on 31.3.2014	4,90,100
Add: Profit for 2014-15	4,71,900
	9,62,000
Less: Dividend	84,500
	8,77,500

(iii) During 2014-15 machinery costing ₹ 2,92,500 was sold for ₹ 97,500.
(iv) Investments which were sold for ₹ 1,17,000 had cost ₹ 97,500.
(v) Provision for taxation and dividend are to be taken as non-current liabilities. *[CA (PE-II) — Adapted]*

Solution

Sneha Ltd.

Statement of Sources and Application of Funds for the year ended 31.3.2015

Sources	₹	Applications	₹
Issue of Equity Shares	3,90,000	Redemption of 10% Debentures	3,25,000
Sale of Machinery	97,500	Purchase of Machinery (Note 3)	7,86,500
Sale of Investment	1,17,000	Payment of Dividend	42,250
Funds from Operations	16,70,500	Payment of Tax (Note 7)	2,60,000
		Increase in Working Capital	8,61,250
	22,75,000		22,75,000

Schedule of Changes in Working Capital for the year ended 31.3.2015

Particulars	31.3.2014 ₹	31.3.2015 ₹	Effect on Working Capital Increase	Effect on Working Capital Decrease
Current Assets (A)				
Debtors	4,16,000	11,70,000	7,54,000	—
Stock	5,07,000	7,99,500	2,92,500	—
Cash	2,60,000	2,92,500	32,500	—
Prepaid Expenses	42,250	52,000	9,750	—
	12,25,250	23,14,000		
Current Liabilities (B)				
Creditors	9,00,000	10,00,000	—	1,00,000
Bills Payable	42,500	1,70,000	—	1,27,500
	9,42,500	11,70,000		
Working Capital (A – B)	2,82,750	14,44,000	—	—
Increase in Working Capital	8,61,250	—	—	8,61,250
	14,44,000	14,44,000	10,88,750	10,88,750

Working Notes :

Dr. **(1) Profit and Loss Adjustment Account** **Cr.**

Particulars	₹	Particulars	₹
To Goodwill (written-off)	22,500	By Balance b/d	4,58,250
To Dividend	84,500	By Profit on Sale of Investment	19,500
To Depreciation on		By Funds from Operations (Balancing figure)	16,70,500
Building	32,500		
Machinery	1,36,500		
To Provision for Taxation	9,75,000		
To Loss on Sale of Machinery (Note 1)	32,500		
To Investment A/c (written-off)	16,250		
To Balance c/d	8,48,500		
	21,48,250		21,48,250

Dr. **(2) Accumulated Depreciation on Building Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.3.2015	To Balance c/d	5,20,000	1.4.2014	By Balance b/d	4,87,500
			31.3.2015	By Depreciation	32,000
		5,20,000			5,20,000

Dr. **(3) Machinery Account (at cost)** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2014	To Balance b/d (₹ 16,18,500 + 15,92,500)	32,11,000	?	By Machinery Disposal A/c	2,92,500
?	To Bank A/c (Balancing figure)	7,86,500	31.3.2015	By Balance c/d (₹ 21,38,500 + 15,66,500)	37,05,000
		39,97,500			39,97,500

Dr. **(4) Accumulated Depreciation on Machinery Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Machinery Disposal A/c (Balancing figure)	1,62,500	1.4.2014	By Balance b/d	15,92,500
31.3.2015	To Balance c/d	15,66,500	31.3.2015	By Depreciation (2014-04)	1,36,500
		17,29,000			17,29,000

Dr. **(5) Machinery Disposal Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
?	To Machinery A/c	2,92,500	?	By Accumulated Depreciation on Machinery	1,62,500
			?	By Bank	97,500
			?	By Loss on Sale of Machinery	32,500
		2,92,500			2,92,500

Dr. **(6) Non Trade Investment Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
1.4.2014	To Balance b/d	5,07,000	?	By Bank A/c (Sale)	1,17,000
?	To Profit on Sale of Investment (₹ 1,17,000 – 97,500)	19,500	31.3.2015	By Profit and Loss A/c (written-off)	16,250
			"	By Balance c/d	3,93,250
		5,26,500			5,26,500

(7) It is assumed that Provision for Taxation for the year 2013-14 has been paid during 2014-15.

KEY POINTS

- A Funds Flow Statement which is prepared from two consecutive Balance Sheets (not prepared directly from the accounts) provides an analysis of the sources of additional funds available to the business through its income-generating operations as well as external funds supplied during the accounting period, and an analysis of the manner in which they have been utilised.
- The main objectives of Funds Flow Statement are :
  1. To summarise the financing and investing activities of the entity, including the extent to which the enterprise has generated funds from operation during the period.
  2. To complete the disclosure of changes in financial position during the period.

THEORETICAL QUESTIONS

1. (a) What do you mean by Funds Flow Statement ?
   (b) What are the objectives of Funds Flow Statement ?
2. What are the advantages and limitations of Funds Flow Statement ?
3. Distinguish between Balance Sheet and Funds Flow Statement.
4. Distinguish between Funds Flow Statement and Cash Flow Statement.
5. What are the differenct methods of calculating Funds from Operation ?

OBJECTIVE QUESTIONS

Multiple Choice

Select the best choice to complete each sentence or answer each question below:

1. Collection from debtors ₹ 50,000 would result in
   A sources of fund
   B use of fund
   C neither source or use of fund.

2. Increase in net working capital is a
   A source of fund
   B use of fund
   C neither source or use of fund
3. Conversion of debentures into equity share capital is a
   A source of fund
   B use of fund
   C neither source or use of fund
4. State which of the following transactions would result in source of fund
   A sale of stock
   B sale of old mahinery
   C sale of short-term investment
5. State which of the following transactions would result in use of fund
   A payment to creditors
   B conversion of preference shares into equity shares
   C repayment of long term loan

PRACTICAL QUESTIONS

1. The Balance Sheets of X Limited as at 31.3.2015 and 31.3.2016 were as follows :

Balance Sheets of X Limited as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	45,000	65,000
(b) Reserves and Surplus	(2)	14,000	22,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) 11% Debentures		10,000	20,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		8,700	11,000
TOTAL		77,700	1,18,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		46,700	83,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		11,000	13,000
(c) Trade Receivables		18,000	19,500
(d) Cash and Cash Equivalents		2,000	2,500
TOTAL		77,700	1,18,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	45,000	65,000

(2) Reserve and Surplus		
General Reserve	5,000	7,500
Profit and Loss Account	9,000	14,500
	14,000	22,000

Prepare a Schedule of Changes in Working Capital and a Statement of Sources and Applications of Funds.

2. From the following summarised financial statements of XYZ Ltd., as at 30.6.2015 and 30.6.2016, prepare : (i) a statement of change in working capital for the year ended 30.6.2016 and (ii) a statement showing sources and application of funds during the same period :

Balance Sheets of XYZ Ltd. as at 30th June, 2015 and 2016

Particulars	Note No.	30.06.2015 (₹)	30.06.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	2,00,000	2,40,000
(b) Reserves and Surplus	(2)	83,000	1,20,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 16% Debentures		1,00,000	90,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		1,80,000	2,20,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Proposed Dividend		20,000	30,000
TOTAL		5,83,000	7,00,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery		3,60,000	4,10,000
(b) Non-current Investments		40,000	50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,00,000	1,40,000
(c) Trade Receivables		80,000	98,000
(d) Cash and Cash Equivalents		3,000	2,000
TOTAL		5,83,000	7,00,000

Notes to Accounts :

Particulars	30.06.2015 (₹)	30.06.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	2,00,000	2,40,000
(2) Reserve and Surplus		
General Reserve	63,000	90,000
Profit and Loss	20,000	30,000
	83,000	1,20,000

During the year ended 3.6.2016, depreciation charged on fixed assets amounted to ₹ 50,000. The final divided for the year ended 30.6.2015 amounting to ₹ 20,000 was paid on 10.2.2016.

3. From the following summarised Financial Statement of Raghaban Ltd. as on 1.4.2015 and 31.3.2016 prepare :
(a) Statement of Change in Working Capital for the year ended 31.3.2016 and
(b) a Statement showing Sources and Application of Fund during the same year.

Balance Sheets of Raghaban Ltd. as at 1st April, 2015 and 31st March, 2016

Particulars	Note No.	01.04.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	5,00,000	6,00,000
(b) Reserves and Surplus	(2)	3,00,000	3,75,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		2,50,000	2,50,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		4,50,000	5,25,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Proposed Dividend		50,000	75,000
TOTAL		15,50,000	18,25,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery (Net)		9,00,000	10,25,000
(b) Non-current Investments		1,00,000	1,25,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		2,50,000	3,50,000
(c) Trade Receivables		2,92,500	3,20,000
(d) Cash and Cash Equivalents		7,500	5,000
TOTAL		15,50,000	18,25,000

Notes to Accounts :

Particulars	1.4.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	5,00,000	6,00,000
(2) Reserve and Surplus		
General Reserve	2,50,000	3,00,000
Profit and Loss	50,000	75,000
	3,00,000	3,75,000

During the year ended 31.3.2016, the depreciation charged on fixed assets amounted to ₹ 1,25,000. The final dividend for the year ended 31.3.2015 amounted to ₹ 50,000 was paid on 15.1.2016.

4. From the following Balance Sheets of ABC Ltd. make out :
(i) Statement of Changes in Working Capital; and (ii) Funds Flow Statement.

Balance Sheets of ABC Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	4,50,000	5,00,000
(b) Reserves and Surplus	(2)	70,000	1,18,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		75,000	99,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions	(3)	82,000	1,00,000
TOTAL		6,77,000	8,17,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(4)	2,80,000	3,70,000
(ii) Intangible Assets — Goodwill		1,15,000	90,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		77,000	1,09,000
(c) Trade Receivables		1,80,000	2,30,000
(d) Cash and Cash Equivalents		25,000	18,000
TOTAL		6,77,000	8,17,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	3,00,000	4,00,000
8% Redeemable Preference Shares	1,50,000	1,00,000
	4,50,000	5,00,000
(2) Reserve and Surplus		
General Reserve	40,000	70,000
Profit and Loss	30,000	48,000
	70,000	1,18,000
(3) Short-term Provisions		
Proposed Dividend	42,000	50,000
Provision for Taxation	40,000	50,000
	82,000	1,00,000
(4) Tangible Assets		
Land and Building	2,00,000	1,70,000
Plant	80,000	2,00,000
	2,80,000	3,70,000

Additional information :

(a) Depreciation of ₹ 10,000 and ₹ 20,000 were charged on Plant and Buildings respectively in 2015.

(b) An interim dividend of ₹ 20,000 was paid in 2015.

(c) Income-tax of ₹ 35,000 was paid during the year 2015.

5. Prepare (i) A Statement of Changes in Working Capital; and (ii) A Funds Flow Statement from the following data [all figures in ₹] :

Particulars	31 Dec., 2014	31 Dec., 2015
Cash	2,000	2,500
Accounts Receivable	2,400	2,700
Inventories	3,100	3,200
Other Assets (Current)	800	700
Fixed Assets	5,000	5,800
Accumulated Depreciation	2,100	2,500
Accounts Payable	2,000	2,100
Long-term Debt	1,400	1,300
Equity Capital	5,000	5,300
Retained Earnings	2,800	3,700

Notes :

(a) Fixed assets costing ₹ 1,200 were purchased for cash.

(b) Fixed assets (original cost ₹ 400, accumulated depreciation ₹ 150) were sold for ₹ 200.

(c) Depreciation for the year 2015 amounted to ₹ 550 and duly debited to Profit and Loss Account.

(d) Dividends paid amounted to ₹ 300 in 2015.

(e) Reported income for 2015 was ₹ 1,200.

6. The Balance Sheet of National Plastics Ltd. as on 31.12.2014 and on 31.12.2015 are given below :

Balance Sheets of National Plastics Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	6,00,000	7,00,000
(b) Reserves and Surplus	(2)	60,800	1,44,200
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 8% Debentures		1,00,000	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		—	—
(c) Other Current Liabilities		1,28,000	1,36,000
TOTAL		8,88,800	9,80,200
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	6,12,000	6,48,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,00,000	1,20,000
(c) Trade Receivables		76,000	1,00,000
(d) Cash and Cash Equivalents		1,00,800	1,12,200
TOTAL		8,88,800	9,80,200

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	6,00,000	7,00,000
(2) Reserve and Surplus		
Securities Premium	—	20,000
Profit on Sale of Freehold Property	—	4,000
Profit and Loss	60,800	1,20,200
	60,800	1,44,200
(4) Tangible Assets		
Freehold Property (at Cost)	40,000	32,000
Plant and Machinery	5,72,000	6,16,000
	6,12,000	6,48,000

The entire Share Capital of the Company was issued for cash. Depreciation on Plant and Machinery written off for the year 2015 amounted to ₹ 56,000. During the year, the company paid a dividend of ₹ 30,000. Prepare for the year (a) A Statement of Changes in Working Capital; and (b) A Statement of Sources and Application of Funds.

7. From the following Balance Sheets of XYZ Ltd., make out (i) A Statement of Change in Working Capital; and (ii) A Fund Flow Statement for the year 2015.

Balance Sheets of XYZ Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	4,50,000	5,00,000
(b) Reserves and Surplus	(2)	55,000	1,08,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables	(3)	45,000	63,000
(c) Other Current Liabilities		30,000	36,000
(d) Short-term Provisions	(4)	82,000	1,00,000
TOTAL		6,62,000	8,07,000
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(5)	2,80,000	3,70,000
(ii) Intangible Assets — Goodwill		1,00,000	80,000
(b) Non-current Investments		20,000	30,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		77,000	1,09,000
(c) Trade Receivables		1,60,000	2,00,000
(d) Cash and Cash Equivalents		25,000	18,000
TOTAL		6,62,000	8,07,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	3,00,000	4,00,000
8% Redeemable Preference Shares	1,50,000	1,00,000
	4,50,000	5,00,000
(2) Reserve and Surplus		
Capital Reserve	—	20,000
General Reserve	40,000	50,000
Profit and Loss	15,000	38,000
	55,000	1,08,000
(3) Trade Payables		
Sundry Creditors	25,000	47,000
Bills Payables	20,000	16,000
	45,000	63,000
(3) Short-term Provisions		
Proposed Dividend	42,000	50,000
Provision for Taxation	40,000	50,000
	82,000	1,00,000
(4) Tangible Assets		
Land and Building	2,00,000	1,70,000
Plant and Machinery	80,000	2,00,000
	2,80,000	3,70,000

Additional information :

(a) A piece of land has been sold out in 2015 and the profit on sale has been credited to Capital Reserve Account.

(b) A machine has been sold for ₹ 10,000. The written-down value of the machinery was ₹ 12,000. Depreciation of ₹ 10,000 is charged on Plant Account in 2015.

(c) An interim dividend of ₹ 20,000 has been paid in 2015.

8. The summarised Balance Sheet of XYZ Ltd. as on 31st December, 2014 and 31st December, 2015 are given below:

Balance Sheets of XYZ Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	4,50,000	4,50,000
(b) Reserves and Surplus	(2)	3,56,000	3,78,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — Mortgage Loan		—	2,70,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		1,68,000	1,34,000
(c) Other Current Liabilities		—	—
(d) Short-term Provisions — Provision for Taxation		75,000	10,000
TOTAL		10,49,000	12,42,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets		4,00,000	3,20,000
(b) Non-current Investments		50,000	60,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		2,40,000	2,10,000
(c) Trade Receivables		2,10,000	4,55,000
(d) Cash and Cash Equivalents		1,49,000	1,97,000
TOTAL		10,49,000	12,42,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
45,000 Equity Shares of ₹ 10 each fully paid	4,50,000	4,50,000
(2) Reserve and Surplus		
General Reserve	3,00,000	3,10,000
Profit and Loss Account	56,000	68,000
	3,56,000	3,78,000

Additional information :

(i) Investments costing ₹ 8,000 were sold during the year 2015 for ₹ 8,500.
(ii) Provision for tax made during the year was ₹ 9,000.
(iii) During the year part of the fixed assets costing ₹ 10,000 were sold for ₹ 12,000 and the profit was included in Profit and Loss Account;
(iv) Dividend paid during the year amounted to ₹ 40,000; and
(v) Provision for tax should be treated as current liability.

You are required to prepare :

(i) A Statement of Changes in Working Capital;
(ii) A Statement of Sources and Application of Funds.

9. From the following Balance Sheets of PM Ltd. make out —
(i) A Statement of Changes in Working Capital; and (ii) A Fund Flow Statement for the year 2015.

Balance Sheets of PM Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹ in Lakhs)	31.12.2015 (₹ in Lakhs)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	15.00	15.00
(b) Reserves and Surplus	(2)	13.00	15.00
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		—	—
(c) Other Current Liabilities		10.00	6.00
TOTAL		38.00	36.00

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant at W.D.V.		15.00	18.00
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		6.00	3.00
(c) Trade Receivables		15.00	10.00
(d) Cash and Cash Equivalents		2.00	5.00
TOTAL		38.00	36.00

Notes to Accounts :

Particulars	31.12.2014 (₹ in Lakhs)	31.12.2015 (₹ in Lakhs)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 100 each fully paid	10.00	15.00
Redeemable Preference Shares of ₹ 100 each, ₹ 50 paid	5.00	—
	15.00	15.00
(2) Reserve and Surplus		
Securities Premium	0.25	—
Capital Redemption Reserve	—	5.00
General Reserve	10.00	7.00
Profit and Loss	2.75	3.00
	13.00	15.00

Additional information :

(a) During 2015 the Company paid ₹ 2,00,000 as Equity Dividend and ₹ 56,250 as Preference Dividend.

(b) The company redeemed the Preference Shares at premium of 5% after making a call of ₹ 50 per share to make the shares fully paid.

(c) During the year 2015 one plant whose book value was ₹ 1,00,000 was sold at a loss of ₹ 20,000 and the company purchased a plant for ₹ 6,00,000.

10. The summarised Balance Sheets of X Ltd. as on 31st March 2015 and on 31st March 2016 are as follows :

Balance Sheets of X Ltd. as at 31st March, 2015 and 2016

Particulars	Note No.	31.03.2015 (₹)	31.03.2016 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	6,00,000	7,00,000
(b) Reserves and Surplus	(2)	4,20,000	5,50,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 10% Debentures		4,00,000	2,80,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		2,40,000	2,60,000
(c) Other Current Liabilities — Unclaimed Dividend		—	8,000
(d) Short-term Provisions	(3)	2,40,000	2,42,000
TOTAL		19,00,000	20,40,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets — Plant and Machinery	(4)	11,40,000	12,20,000
(b) Non-current Investments — Trade Investments		2,00,000	1,60,000
(2) Current Assets :			
(e) Short-term Loans and Advances		—	—
(f) Other Current Assets		5,60,000	6,60,000
TOTAL		19,00,000	20,40,000

Notes to Accounts :

Particulars	31.03.2015 (₹)	31.03.2016 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	6,00,000	7,00,000
(2) Reserve and Surplus		
Capital Reserve	—	20,000
General Reserve	3,40,000	4,00,000
Profit and Loss Account	1,80,000	1,30,000
	4,20,000	5,50,000
(3) Short-term Provisions		
Provision for Taxation	1,80,000	1,70,000
Proposed Dividend	60,000	72,000
	2,40,000	2,42,000
(4) Tangible Assets		
Plant and Machinery (at Cost)	16,00,000	19,00,000
Less: Depreciation	4,60,000	6,80,000
	11,40,000	12,20,000

During the year ended 31st March 2016 the company:

(i) Sold one machine for ₹ 50,000; the cost of the machine was ₹ 1,28,000 and the depreciation provided for it was ₹ 70,000.

(ii) Redeemed 30% of debenture @ ₹ 103.

(iii) Sold some trade investments at a profit which was credited to Capital Reserve.

(iv) Paid income tax ₹ 1,65,000.

Prepare the Fund Statement for the year ended 31st March, 2016.

11. The following is the Balance Sheet of Ganesh Mills Ltd. :

Balance Sheets of Ganesh Mills Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	5,00,000	4,00,000
(b) Reserves and Surplus	(2)	3,50,000	4,30,000
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :			
(a) Long-term Borrowings — 12% Debentures		2,00,000	3,00,000
(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		80,000	1,40,000
TOTAL		11,30,000	12,70,000

II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	5,70,000	6,38,000
(b) Non-current Investments		1,00,000	1,50,000
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		3,00,000	2,50,000
(c) Trade Receivables		1,40,000	2,00,000
(d) Cash and Cash Equivalents		20,000	32,000
TOTAL		11,30,000	12,70,000

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each	3,00,000	4,00,000
10% Redeemable Preference Shares	2,00,000	—
	5,00,000	4,00,000
(2) Reserve and Surplus		
Capital Redemption Reserve	—	1,00,000
Reserve Fund	2,00,000	1,20,000
Securities Premium	30,000	30,000
Profit and Loss	1,20,000	1,80,000
	3,50,000	4,30,000
(3) Tangible Assets		
Building	2,50,000	3,00,000
Machinery	3,00,000	3,20,000
Furniture	20,000	18,000
	5,70,000	6,38,000

The following transactions took place during the year 2015 :

(a) Preference shares were redeemed at 10% premium.

(b) ₹ 20,000 were transferred to Reserve Fund from Profit and Loss Account.

(c) Investments (Book value ₹ 40,000) were sold for ₹ 70,000.

(d) Depreciation provided on Building, Machinery and Furniture ₹ 20,000, ₹ 30,000 and ₹ 2,000 respectively.

(e) Dividend paid ₹ 50,000 and income tax paid ₹ 45,000.

Prepare Funds Flow Statement and a Statement showing Change in Working Capital. ***[B.Com (Bangalore) — Adapted]***

12. The following are the summaries of the Balance Sheets of AB Ltd. as on 31st December, 2014 and 31st December, 2015 :

Balance Sheets of AB Ltd. as at 31st December, 2014 and 2015

Particulars	Note No.	31.12.2014 (₹)	31.12.2015 (₹)
(1)	(2)	(3)	(4)
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds :			
(a) Share Capital	(1)	2,00,000	2,60,000
(b) Reserves and Surplus	(2)	89,690	91,220
(2) Share Application Money Pending Allotment :		—	—
(3) Non-current Liabilities :		—	—

(4) Current Liabilities :			
(a) Short-term Borrowings		—	—
(b) Trade Payables		73,280	52,660
(c) Other current liabilities		—	—
(d) Short-term provisions — Provision for Taxation		40,000	50,000
TOTAL		4,02,970	4,53,880
II. ASSETS			
(1) Non-current Assets :			
(a) Fixed Assets			
(i) Tangible Assets	(3)	2,61,490	2,80,520
(b) Non-current Investments		—	—
(2) Current Assets :			
(a) Current Investments		—	—
(b) Inventories		1,11,000	97,300
(c) Trade Receivables		87,490	73,360
(d) Cash and Cash Equivalents		(57,010)	2,700
TOTAL		4,02,970	4,53,880

Notes to Accounts :

Particulars	31.12.2014 (₹)	31.12.2015 (₹)
(1) Share Capital		
Issued, Subscribed and Paid-up Capital :		
Equity Shares of ₹ 10 each fully paid	2,00,000	2,60,000
(2) Reserve and Surplus		
General Reserve	45,000	45,000
Profit and Loss	44,690	46,220
	89,690	91,220
(3) Tangible Assets		
Land and Building	1,48,500	1,44,250
Plant and Machinery	1,12,990	1,36,270
	2,61,490	2,80,520

The following additional information is obtained from the General Ledger :

(i) During the year ended 31st December, 2015 an interim dividend of ₹ 26,000 was paid.

(ii) The assets of another company were purchased for ₹ 60,000 payable in fully paid shares of the company. These assets consisted of stock ₹ 21,640 and machinery ₹ 38,360. In addition, sundry purchase of plant were made totalling ₹ 5,650.

(iii) Income tax paid during the year amounted to ₹ 25,000.

(iv) The net profit for the year before tax was ₹ 62,530.

(v) Provision for taxation to be treated as a non-current liability.

Prepare a Statement showing the Sources and Application of Funds for the year 2015 and a Schedule setting out Changes in Working Capital.

13. The following information relates to the business of Progressive Ltd for the year ended 31st December, 2015 :

(i) The trading results disclosed an operating profit of ₹ 2,50,000.

(ii) The position of some Fixed Assets at the year end was as follows :

Particulars	2015 (₹)	2014 (₹)
Machinery and Plant	11,80,000	10,00,000
Buildings	6,00,000	5,00,000
Land	50,000	40,000
Construction-in-progress	—	1,60,000
	18,30,000	17,00,000
Less: Accumulated Depreciation	6,10,200	4,50,000
	12,19,800	12,50,000

(iii) Construction-in-progress at 31st December, 2014 included ₹ 50,000 for an addition to the Company's main building and the balance for machinery and plant. Upon completion of the addition in June 2015, the construction costs were transferred to the appropriate accounts.

(iv) particulars of disposal of plants during 2015 :

Particulars	Year of Purchase	Cost (₹)	Sale Value (₹)
Plant 'A'	2010	30,000	10,000
Plant 'B'	2013	24,000	20,000
Plant 'C'	2007	5,000	(abandoned as useless)

Depreciation is always provided annually on a straight line basis @ 10% (other than on land).

(v) Building Account included a credit entry of ₹ 7,000 representing a refund of an amount billed twice in error during April, 2015.

(vi) A debit of ₹ 6,000 appeared in the Accumulated Depreciation Account during the year representing the cost of two electric motors. These motors replacd two similar motors purchased 12 years ago for approximately the same cost and were fully depreciated and written off.

(vii) Cost of Building included ₹ 5,000 architect's fees which were paid by the issue of 500 Equity Shares of the company.

(viii)The following further information is given :

(1) Patent rights purchased for ₹ 10,000.
(2) Nominal value of preference shares for ₹ 60,000 redeemed at a premium of 10%.
(3) Debentures converted into preference shares ₹ 25,000.
(4) Amortisation of patent rights ₹ 2,000.
(5) Non-operating income ₹ 35,000
Non-operating expenses ₹ 22,000.
(6) Issue of new Euity Shares ₹ 50,000.
(7) Capitalisation of reserves by issue of bonus shares ₹ 30,000.
(8) Working capital on 31st December, 2015 was ₹ 2,62,200 more than the same on 31st Deember 2014.

You are required to prepare a Fund Flow Statement for the year ended 31st December, 2015.

14. A and B are carrying on business in partnership since January 2014 sharing profits and losses in the ratio of 3 : 2. Not all the necessary books and records have been maintained. However, the following figures have been ascertained from the available records :

	Particulars	31st Dec. 2014 ₹	31st Dec. 2015 ₹
(i)	Drawings for the year		
	A	5,000	15,000
	B	10,000	10,000
(ii)	Sundry Creditors	24,000	27,000
(iii)	Stock	30,000	50,000
(iv)	Sundry Debtors	28,000	48,000
(v)	Profit for the year	15,000	28,425
(vi)	Purchase of Machineries	25,000	15,000
(vii)	Purchase of Furniture	10,000	—
(viii)	Bills Payable	12,000	7,000
(ix)	Bills Receivable	8,000	6,000
(x)	Sale of Furniture	—	2,000
(xi)	Bank Loan obtained	—	50,000
(xii)	Bank Loan discharged	—	10,000
(xiii)	Salaries Outstanding	—	2,000
(xiv)	Prepaid Insurance	—	500

Cash in hand and at bank amounted to ₹ 7,000 on December 31, 2015. Partners have been regularly charging deprecaition on Machineries @ 10% and on Furniture @ 5% excluding sold items.

In 2014, A and B introduced further capital of ₹ 10,000 and ₹ 15,000 respectively (other than initial capial brought in).

On 31st December, 2014 the assets of business included Cash and Bank balances. Book value of Furniture sold was ₹ 3,000.

You are required to prepare a Satement Showing Sources and Appliation of Funds for the year ended 31st December, 2015. Show your workings properly.

Guide to Answers

Multiple Choice

1. (c) neither source or use of fund; 2. (b) use of fund; 3. (c) neither source or use of fund; 4. (b) sale of old machinery; 5. (c) repayment of long-term loan.

Practical Questions

Sl. No.	Increase/(Decrease) in Working Capital	Total of Funds Flow Statement	Funds from Operation	Remarks
1.	1,700	38,000	8,000	—
2.	17,000	1,57,000	1,17,000	Proposed dividend has been treated as non-current liabilities.
3.	50,000	3,75,000	2,75,000	-do-
4.	41,000	2,83,000	1,73,000	Provision for taxation has been treated as current liabilities.
5.	700	2,300	—	—
6.	47,400	2,77,400	—	—
7.	31,000	2,95,000	1,35,000	Provision for taxation has been treated as current liabilities and proposed dividend has been treated as non-current liabilities.
8.	3,62,000	4,20,000	1,29,500	It has been assumed that investments are long term.
9.	(–) 1,00,000	19,06,250	7,26,250	—
10.	90,000*	6,93,600	4,83,600	* without considering unclaimed dividend as current liabilities. If unclaimed dividend is treated as current liability then increase in working capital will be ₹ 82,000.
11.	(–) 38,000	5,25,000	2,17,000	—
12.	52,500	1,09,150	87,510	—
13.	—	5,28,200	4,35,200	Operating Profit ₹ 2,49,400; Depreciation for the period ₹ 1,78,600.
14.	35,500	85,500	—	Cash in hand and cash at bank ₹ 10,000 and ₹ 7,000 on 31.12.2014 and 31.12.2015 respectively.