

PAPER – 5 ADVNCD ACCOUNTING

S.NO	CHAPTER NAME	PAGE.NO
1.	Fundamentals & Introduction to Advanced Accounting	4-8
2(A).	AS 20: Earnings Per Share	9-17
2(B).	AS 4: Contingencies and Events Occurring after the Balance Sheet Date	18-24
2(C).	AS 22: Accounting for Taxes on Income	25-32
2(D).	AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	33-38
2(E).	AS 9: Revenue Recognition	39-47
2(F).	AS 7: Construction Contracts	48-57
3.	Amalgamation of Companies+AS-14	58-89
4.	Accounting for Reconstruction of Companies	90-103
5.	Accounting for Liquidation of Companies	104-120
6(A).	AS 19: Leases	121-130
6(B).	AS 18: Related Party Disclosures	131-135
6(C).	AS 17: Segment Reporting	136-145
6(D).	AS 26: Intangible Assets	146-156
6(E).	AS 29: Provisions, Contingent Liabilities and Contingent Assets	157-171
6(F).	AS 24: Discontinuing Operations	172-174
7(A).	Partnership accounts-Dissolution of partnership firms	175-192
7(B).	Partnership accounts- Amalgamation, conversion and slae of partnership firms	193-201
8.	Consolidated Financial statements	202-221
19.	Accounting for Employee Stock Option Plans	222-234
10.	Buy Back of Securities and Equity Shares with Differential Rights	235-249
11.	Banking companies	250-285
12.	Non-Banking Financial Companies	286-296

Author: Satya Raju, FCA, DISA, B.com

BLUE PRINT AS PER ICAI

Intermediate Course Paper 5: Advanced Accounting (100 Marks)

Sections	Weightage	content Area
I	20% -26%	1. Applications of Accounting Standards
		AS 4: Contingencies and Events Occurring after the Balance Sheet Date
		AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
		AS 7: Construction Contracts
		AS 9: Revenue Recognition
		AS 14: Accounting for Amalgamations
		AS 17: Segment Reporting
		AS 19: Leases
		AS 20: Earnings Per Share
		AS 22: Accounting for Taxes on Income
		AS 24: Discontinuing Operations
		AS 26: Intangible Assets
		AS 29: Provisions, Contingent Liabilities and Contingent Assets
II	33% -38%	Company Accounts
II (A)		2.special Aspects of company Accounts
		(i)Accounting for employee stock option plans
		(ii) Buy back of securities
		(iii) Equity shares with differential rights
III (B)		3.Reorganisation and liquidation of companies
		(i)Accounting for Amalgamation (excluding inter – company holding) and reconstruction
		(ii) Accounting involved in liquidation of companies
III	12% -16%	4. Banking companies and Non – Banking financial companies and regulatory requirements thereof
IV	25% - 30%	5.Consolidated financial statements

		Concept of consolidation and simple problems on consolidated financial statements with single subsidiary (excluding problems involving acquisition of interest in subsidiary at different dates, different reporting dates of holding and subsidiary and foreign subsidiaries)
		6. Dissolution of partnership firms
		Dissolution of partnership firms including piecemeal distribution of assets, Amalgamation of partnership firms, conversion of partnership firm into company and sale to a company, issues related to accounting in limited liability partnership.

CA SATYA RAJU

1.FUNDAMENTALS & INTRODUCTION OF ACCOUNTING

1. MEANING OF ACCOUNTING:

Accounting is the art of Recording, Classifying, Summarizing the transactions and events which have financial Character, Analyzing and Interpreting the result there of.

2. TRANSACTIONS & EVENTS:

a) Transaction refers to any exchange of goods and services on cash or credit basis by the business with outside parties.

Conclusion: Transaction is a Cause.

b) An Event may be described as anything that occurs as a result of something. I.e Event is the Final outcome of Transaction. Conclusion: Event is an effect.

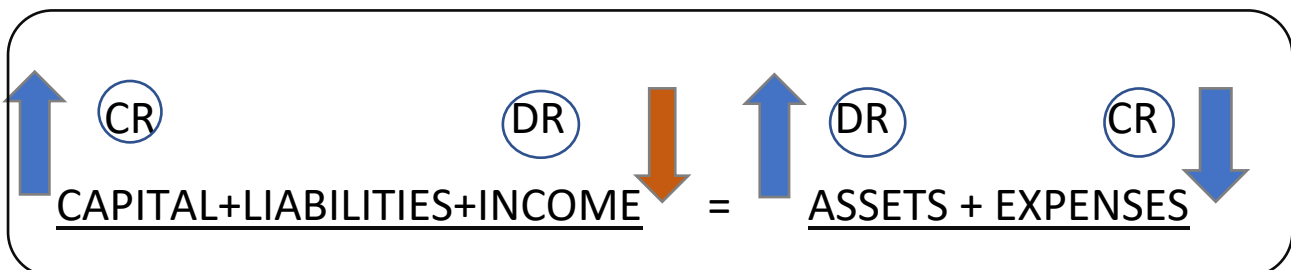
Example: Suppose Alpha Ltd. is a supplier of cycles, which costs Rs. 4200 per cycle. Beta Ltd. purchases 20 cycles from Alpha Ltd. @ Rs. 5000 per cycle. The purchasing and selling that took place between the two business entities is a transaction, while the reduction in stock and profit earned is an event.

3. RECORDING:

Business transactions having financial character are recorded in the book of "JOURNAL". This book is further divided into several Subsidiary books.

a) HOW TO RECORD?

Ans: Based on Accounting Equation



4. CLASSIFYING:

The book containing classified information called as "Ledger". It involves grouping of transactions of one nature at one place so as to put information in compact and usable form.

5. SUMMARISING:

Preparation of Trial balance and Financial Statements come under this process.

6. ANALYSING:

It is concerned with establishment of relationship between the items of profit & Loss Account and Balance sheet for decision making purpose. It also provides the basis for Interpretation.

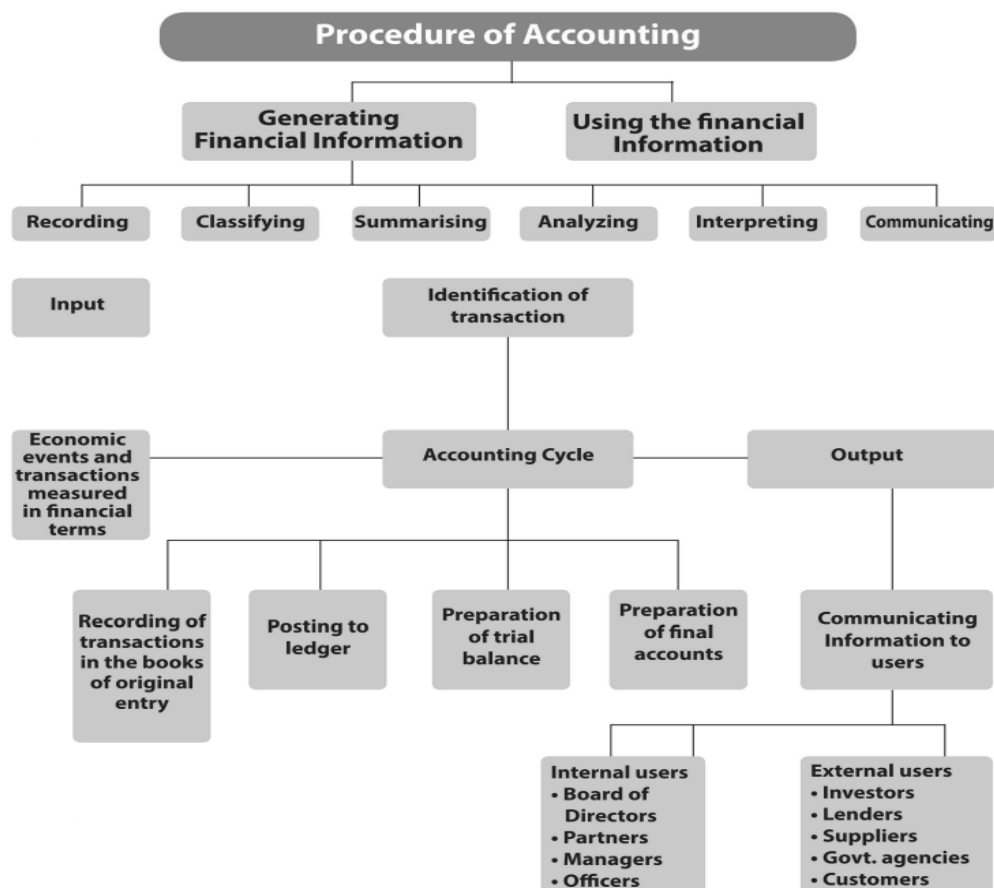
EX: Ratio analysis, Horizontal analysis, Vertical analysis etc.

7. INTERPRETING:

It is concerned with explaining the meaning and significance of the relationship as established by the analysis of Accounting data. Based on Interpretations, end users will take appropriate decisions.

8. COMMUNICATING:

It is concerned with the transmission of summarised, analysed and interpreted information to the end users to enable them to take rational decisions. This involves distribution of Various Accounting reports, Ratios, Graphs, Diagrams, Fundflow statement etc.



9. WHAT IS GAAP?

Generally Accepted Accounting principles are basic accounting principles and Guidelines which provide the framework for detailed & comprehensive accounting, Accounting standards and other industry specific accounting practices.

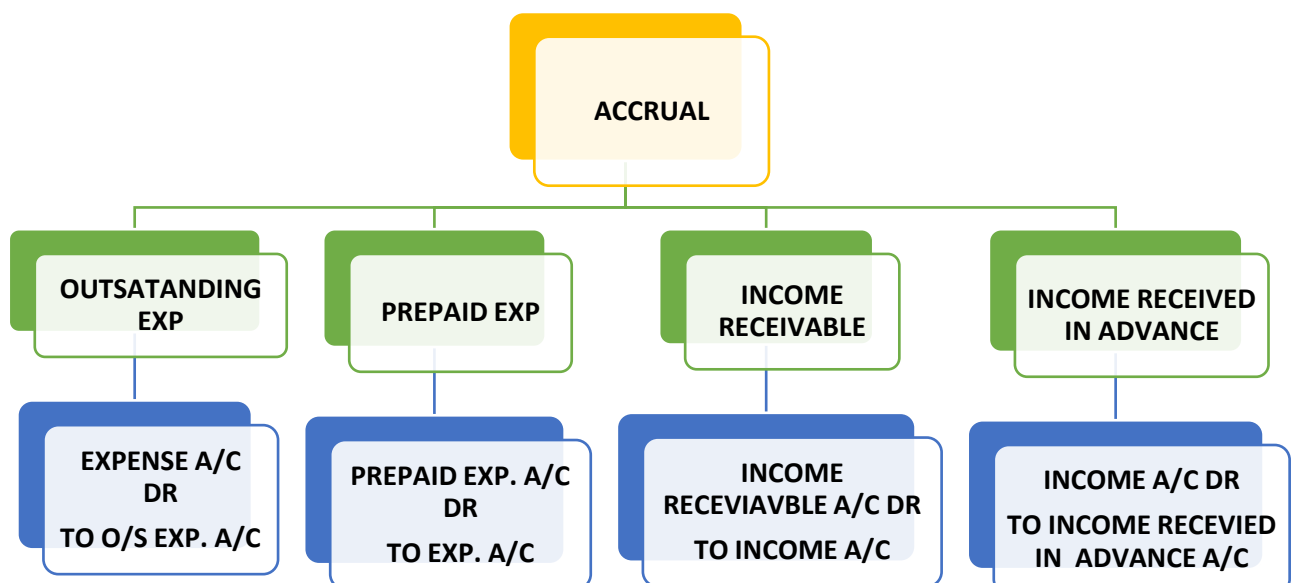
GAAP is a combination of authoritative standards (set by policy boards) and the commonly accepted ways of recording and reporting accounting information. At international level, such authoritative standards are known as International Financial Reporting Standards (IFRS) at many places and in India we have authoritative standards named as Accounting Standards (ASs) and Indian Accounting Standard (Ind AS).

COMMON SET OF ACCEPTED ACCOUNTING PRINCIPLES:

- (a) Business entity Assumption
- (b) Monetary unit Assumption
- (c) Going concern Assumption
- (d) Consistency concept
- (e) Accrual Concept
- (f) Historical cost concept
- (g) Matching concept
- (h) Conservatism principle
- (i) Materiality

10. ACCRUAL CONCEPT:

This principle requires all revenue and expenditure to be recorded in the period it is actually incurred and not when cash or cash equivalent has been received/paid.



11. WHAT IS THE DIFFERENCE BETWEEN ACCRUED & DUE-ACCRUED BUT NOT DUE?

Will be discussed in class room

12. MEANING OF ADJUSTMENTS GIVEN BELOW TRIAL BALANCE:

If any item which is given below trial balance means which is not accounted so far. That means such item impact should consider now into books of Accounts.

EX:

- a) Closing stock given below trial balance for 100000. This means, So far closing stock not recorded into books of accounts. Now you can pass adj entry as closing stock a/c debit and Trading A/c as credit.
- b) Closing stock given in trial balance for 100000. This means, Closing stock was previously considered in books of accounts by making Closing stock debit and purchases credit. Now purchases mentioned in trial balance was after reduction with closing stock.

13. DIFFERENCE BETWEEN RESERVE AND PROVISION:

PARTICULARS	RESERVE	PROVISION
MEANING	The portion of profit kept aside for <u>unforeseen obligations</u> of a business.	Portion of money from the business set aside for meeting <u>known liabilities or expenses</u> .
CHARGE OR APPROPRIATION	<u>Appropriation</u> of profits	<u>Charge against</u> profits
Dividend payment	Useful	Not useful
Presentation in financials	Shown in Reserves & Surplus Under Share holders fund.	Either Reduced from Asset or shown under Liabilities.

14. SOME IMPORTANT DIFFERENCES BETWEEN VARIOUS TYPES OF ENTITIES:

Basis	Sole proprietorship	Partnership	HUF	Co. operative Society	Joint Stock Company
Registration	Not Required	Optinal	Not Required	Compulsory	Compulsory

Formation	No Legal Formalities	Less Legal Formalities	Less Leagal Formalities	Greater Legal Formalities	Greater Legal Formalities
Members	Only Owner	Minimum -2 Maximum -100	Minimum -2 Maximum – No limt	Minimum -2 Maximum - No limited	Minimum Private -2 Public -7 Maximum Private -50 Public – no Limit
Capital	Limited	Comparatively More than sole Proprietor ship	Ancestral Property	limited	Large Financial Resources
Liability	Unlimited	Unlimited	Unlimited Karta Limited Other Members	Limited	Limited
Management	Owner	Partner	Karta	Managing Committee	Board of Directors
Continuity	Unstable	Unstable	Stable	Stable	Stable

2(A) AS-20 EARNINGS PER SHARE

INTRODUCTION & OBJECTIVE:

1. Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.
2. The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.
3. EPS is useful for computation of Market price per share. $M.P.S = E.P.S \times P/E \text{ ratio}$.

SCOPE:

1. This Standard should be applied by all the entities. However, a Small and Medium Sized Company and a Small and Medium Sized non-corporate entity falling in Level II or Level III or Level IV 'Applicability of Accounting Standards to Various Entities', may not disclose diluted earnings per share.
2. In consolidated financial statements, the information required by this Standard should be presented on the basis of consolidated information.

MEASUREMENT:

BASIC EARNINGS PER SHARE:

Net profit (loss) attribute to equity share holders
Weighted average number of equity shares outstanding during the period

EARNINGS ATTRIBUTABLE TO EQUITY SHARE HOLDERS:

PARTICULARS	AMOUNT RS.
PROFIT AFTER TAX (PAT)	XXXX
LESS: PREFERENCE DIVIDEND	(XXXX)
LESS: DIVIDEND DISTRIBUTION TAX ON PREFERENCE DIVIDEND IF APPLICABLE	(XXXX)
EARNINGS AVAILABLE TO EQUITY SHARE HOLDERS	XXXX

IMPORTANT POINTS ON EAESH:

1. 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.
2. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period in order to calculate the net profit or loss for the period attributable to equity shareholders.
3. The amount of preference dividends for the period that is deducted from the net profit for the period is:
 - a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and
 - b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.
4. 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.

WEIGHTED AVERAGE NUMBER OF EQUITY SHARES:

$\text{WANES} = \frac{\text{NO.OF EQUITY SHARES OUT STANDING} \times \text{PERIOD VALUE WEIGHT} \times \text{PAID-UP VALUE}}{\text{WEIGHT}}$
--

- A) Period value weight = No. of months outstanding during the year /12 months.
- B) Paid-up value weight= Paid-up value towards face value/ Face value.
- C) Number of Equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period.

Effective date: It means the date from which shares are included in the weighted average number of shares. I.e In generally from the date the consideration is receivable.

1. Equity shares issued in exchange for cash are included when cash is receivable;
2. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;
3. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;
4. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;
5. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and
6. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.
7. 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.
8. Equity shares issued 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.

Bonus Issue, Share split:

1. In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources.
2. 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 means along with the impact to current year adjustment, it will also impact the calculation of EPS of last year retrospectively.

Bonus element in Right shares:

1. In a rights issue the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element.
2. 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 adjustment factor.

BONUS ELEMENT

Fair value per share immediately prior to the exercise of rights
Theoretical ex- rights fair value per share

3. 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.

Diluted Earnings Per Share is decrease in Basic EPS due to Dilutive potential Equity shares.

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

Examples:

- a. Debt instruments, that are convertible into equity shares.
- b. Preference shares, that are convertible into equity shares.
- 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;
- 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.

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.

Earnings-Diluted Eps:

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:

1. Any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;
2. Interest recognised in the period for the dilutive potential equity shares; and
3. Any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

WANES-Diluted EPS:

1. 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, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares.
2. 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.
3. Potential equity shares are weighted for the period 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 under WANES.

Measurement of Dilutive EPS:

1. 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.
2. The net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

3. Diluted EPS in case of share options:

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 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. Which is nothing but Bonus element in Options. Such Bonus element in options only considered for calculation Of Dilutive EPS.

Anti-Dilutive Potential Equity Shares:

1. Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.
2. In considering whether potential equity shares are dilutive or antidilutive, each issue or series of potential equity shares is considered separately rather than in aggregate.
3. 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.
4. 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.

Presentation:

1. 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.
2. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.
3. AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

Disclosure:

1. Where the statement of profit and loss includes extraordinary items, basic and diluted EPS computed on the basis of earnings excluding as well as including extraordinary items;
2. The amounts used as the numerators in calculating basic and diluted earnings per share
3. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

Date	Particulars	Purchased	Sold	Balance
1 st January	Balance at beginning of year	1800	-	1800
31 st May	Issue of shares for cash	600	-	2400
1 st November	Buy back of shares	-	300	2100

Calculate weighted number of shares.

(SM)

PROBLEM 2:

Date	Particulars	No. of shares	Face value	Paid up value
1 st January	Balance at beginning of year	1800	Rs.10	Rs.10
31 st October	Issue of shares	600	Rs.10	Rs.5

Calculated Weighted Number of shares.

(SM)

PROBLEM 3:

Net profit for the year 20X1 Rs. 18,00,000

Net profit for the year 20X2 Rs.60,00,000

No. of equity shares outstanding until 30th September 20X2 20,00,000

Bonus issue 1st October 20X2 was 2 equity shares for each equity share outstanding at 30th September, 20X2. Calculate Basic Earnings Per Share.

(SM)

PROBLEM 4:

Net profit for the year 20X1 Rs. 11,00,000

Net profit for the year 20X2 Rs. 15,00,000

No. of shares outstanding prior to rights issue 5,00,000 shares

Rights issue price Rs. 15.00

Last date to exercise rights 1st March 20X2

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 20X2 was Rs. 21.00.

Compute Basic Earnings Per Share.

PROBLEM 5:

Net profit for the current year	Rs.1,00,00,000
No.of.quity shares out standing	50,00,000
Basic earnings per share	Rs.2.00
No.of 12% convertible debentures of Rs.100 each	1,00,000

Each debenture is convertible in to 10 equity shares	
Interest expense for the current year	Rs.12,00,000
Tax relating to interest expense (30%)	Rs.3,60,000

Compute Diluted Earnings per share. (SM)

PROBLEM 6:

Net Profit for The Year 20X1	Rs.12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	Rs.20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	Rs.15.00

Compute Basic and Diluted Earnings Per Share. (SM)

PROBLEM 7:

On 1st April, 20X1 a company had 6,00,000 equity shares of Rs. 10 each (Rs. 5 paid up by all shareholders). On 1st September, 20X1 the remaining Rs. 5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 20X2 was Rs. 21,96,000 after considering dividend on preference shares of Rs. 3,40,000. You are required to compute Basic EPS for the year ended 31st March, 20X2 as per Accounting Standard 20 "Earnings Per Share". (SM-PRACTICAL QUESTION)

PROBLEM 8:

AB Limited is a company engaged in manufacturing industrial packaging equipment. As per the terms of an agreement entered with its debenture holders, the company is required to appropriate adequate portion of its profits to a specific reserve over the period of maturity of the debentures such

that, at the redemption date, the reserve constitutes at least half the value of such debentures. As such appropriations are not available for distribution to the equity shareholders, AB Limited has excluded this from the numerator in the computation of Basic EPS. Is this treatment correct as per provisions of AS 20?

(RTP-NOV 2021-18(a))

PROBLEM 9:

From the following information, you are required to compute Basic and Diluted Earnings Per Share (EPS) of M/s. XYZ Limited for the year ended 31st March, 2019: Net Profit for the year after tax: Rs. 75,00,000 Number of Equity Shares of Rs. 10 each outstanding: 10,00,000. 1,00,000, 8% Convertible Debentures of Rs. 100 each were issued by the Company at the beginning of the year. 1,10,000 Equity Shares were supposed to be issued on conversion. Consider rate of Income Tax as 30%.

(RTP-MAY 2020-17(b))

PROBLEM 10:

Accounting year 01-01-20XX to 31-12-20XX

Earnings, i.e., Net profit attribute to equity shareholders	Rs.1,00,00,000
No.of equity shares out standing	20,00,000
Average fair value of one equity share during the year	Rs.75.00

Potential equity shares

Options	1,00,000 with exercise price of Rs.60
Convertible preference shares	8,00,000 shares entitled to a cumulate dividend of Rs. 8 per share. Each preference share is convertible into 2 equity shares.
Attribute tax, e.g. corporate dividend tax	10%
12% convertible debentures of Rs.100 each	Nominal amount Rs. 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax Rate	30%

Determining the Order in Which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares and also calculate Dilutive EPS.

(ILLUSTRATION-7 OF AS TEXT)

2(B) AS-4 CONTINGENCIES AND EVENTS OCCURRING AFTER BALANCE SHEET DATE

INTRODUCTION:

This Standard deals with the treatment in financial statements of

- (a) contingencies, and
- (b) events occurring after the balance sheet date.

SCOPE:

1. This Standard deal with contingencies are applicable only to that extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard.
2. The following subjects, which may result in contingencies, are excluded from the scope of this Standard.
 - (a) liabilities of life assurance and general insurance enterprises arising from policies issued;
 - (b) obligations under retirement benefit plans; and
 - (c) commitments arising from long-term lease contracts.

CONTINGENCIES:

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Accounting Treatment of Contingent Losses:

The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

Example: ABC has filed case against a debtor for a recovery of ` 25 Lakhs. According to the legal team, the chances of recovery is nil. Therefore, ABC should make provision for doubtful debt.

Accounting Treatment of Contingent Gains:

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

NOTES:

1. The estimation of the amount of a contingent loss to be provided for in the financial statements, may be based on judgement made, by management. If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.
2. The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

Events Occurring 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.

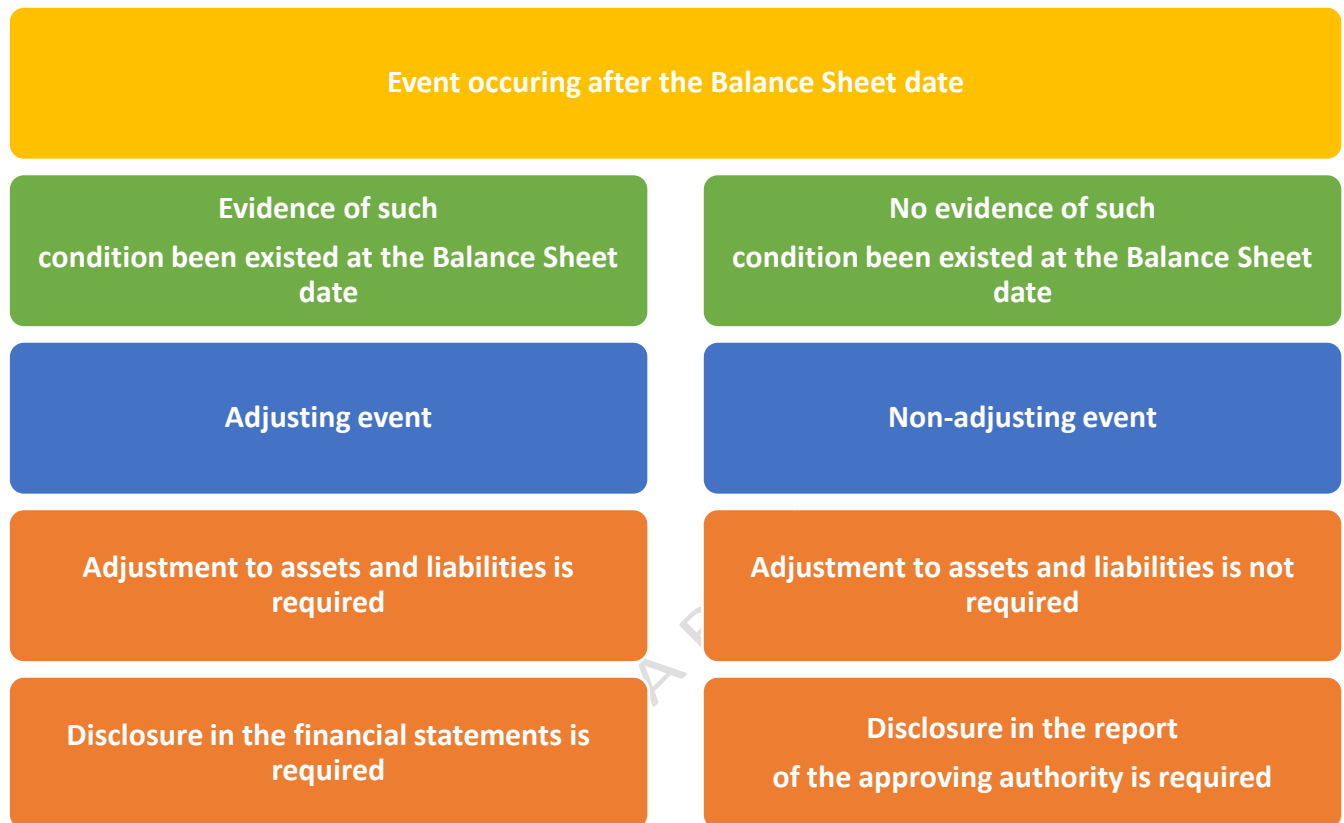
Two types of events can be identified:

1. **Adjusting events**- those which provide further evidence of conditions that existed at the balance sheet date. Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

EXAMPLE: an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer after the balance sheet date due to fire accident occurred in his factory before Balance sheet date.

2. **Non-adjusting events**- those which are indicative of conditions that arose subsequent to the balance sheet date. Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. If these are Material, they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

EXAMPLE: Decline in market value of investments between the balance sheet date and the date on which the financial statements are approved.



Exceptions: There are events which, although take place after the balance sheet date, those which are indicative of conditions that arose subsequent to the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature.

EXAMPLE:

Events indicating going concern assumption inappropriate:

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. In case the going concern assumption is not valid (based on events occurring after the balance sheet date), the financial statements are prepared on a liquidation basis.

NOTE- Dividend declared after balance sheet date

Dividends are declared after the balance sheet date but before the financial statements are approved, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes. Thus, no liability for proposed dividends needs to be recognised in financial statements. Such proposed dividends are to be disclosed in the notes as per Companies (Accounting Standards) Amendment Rules, 2016 issued on 30 March 2016.

CA SATYA RAJU

PROBLEMS FOR DISCUSSION

PROBLEM 1:

A company follows April-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 A/c and crediting the Debtors A/c. The Cheques in hand is shown in balance sheet as an item of cash and cash equivalents. All Cheques in hand are presented to bank in the month of April and are also realized in the same month in normal course after deposit in the bank. Give your comment on Accounting treatment made by the company at par with AS-4 or not? (SM)

PROBLEM 2:

In X Co. Ltd., theft of cash of Rs. 5 lakhs by the cashier in January, 20X1 was detected only in May, 20X1. The accounts of the company were not yet approved by the Board of Directors of the company. Whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.20X1. Decide. (SM)

PROBLEM 3:

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.20X2. The accounting year of the company ended on 31.3.20X2. The accounts were approved on 30.6.20X2. The loss from earthquake is estimated at Rs.30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company. (SM)

PROBLEM 4:

A company has filed a legal suit against the debtor from whom 15 lakh is recoverable as on 31.3.20X1. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 20X1. Can the company provide for full amount of Rs.15 lakhs as provision for doubtful debts? Discuss. (SM)

PROBLEM 5:

In preparing the financial statements of R Ltd. for the year ended 31st March, 20X1, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 20X1 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year. (SM)

PROBLEM 6:

A Limited Company closed its accounting year on 30.6.20X1 and the accounts for that period were considered and approved by the board of directors on 20th August, 20X1. The company was engaged in laying pipeline for an oil company deep beneath the earth. While doing the boring work on 1.9.20X1 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs. 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.20X1. (SM)

PROBLEM 7:

While preparing its final accounts for the year ended 31st March, 20X1 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 20X1 a trade receivable for Rs. 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 20X1 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 20X1? (SM)

PROBLEM 8:

During the year 20X1-20X2, Raj Ltd. was sued by a competitor for Rs. 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of Rs. 10 lakhs in its financial statements for the year ended 31st March, 20X2. On 18th May, 20X2, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of Rs.14 lakhs. The financial statements were prepared by the company's management on 30th April, 20X2, and approved by the board on 30th May, 20X2. Discuss how much provision reported in the year 2011-12 as per AS-4 (SM)

PROBLEM 9:

The financial statements of Alpha Ltd. for the year 20X1-20X2 were approved by the Board of Directors on 15th July, 20X2. The following information was provided:

- i. A suit against the company's advertisement was filed by a party on 20th April, 20X2 claiming damages of Rs. 25 lakhs.
- ii. The terms and conditions for acquisition of business of another company had been decided by March, 20X2. But the financial resources were arranged in April, 20X2 and amount invested was Rs. 50 lakhs.
- iii. Theft of cash of Rs. 5 lakhs by the cashier on 31st March, 20X2, was detected on 16th July, 20X2.

With reference to AS 4, state whether the above mentioned events will be treated as contingencies, adjusting events or non-adjusting events occurring after the balance sheet date. **(SM)**

CA SATYA RAJU

2(C) AS-22 ACCOUNTING FOR TAXES ON INCOME

OBJECTIVE:

1. This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period.
2. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts. This standard is all about how to provide Accounting treatment for such difference.

SCOPE:

1. This Standard should be applied in accounting for taxes on income. taxes on income include all domestic and foreign taxes which are based on taxable income.
2. This Standard does not specify when, or how, an enterprise should account for taxes that are payable on distribution of dividends (If applicable) and other distributions made by the enterprise.

DEFINITIONS:

Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.

Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.

Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

$$\text{Current Tax +/- Deferred Tax} = \text{Tax expense/ (Tax saving)}$$

Current tax is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing differences.

Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Deferred tax is calculated on Timing difference only.

EXAMPLES FOR TIMING DIFFERENCE:

1. Expenses debited in the statement of profit and loss for accounting purposes but allowed for tax purposes in subsequent years.
 - a. Expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the statement of profit and loss on mercantile basis but allowed for tax purposes in subsequent years on payment basis.
 - b. Payments to non-residents accrued in the statement of profit and loss on mercantile basis, but disallowed for tax purposes under section 40(a)(i) and allowed for tax purposes in subsequent years when relevant tax is deducted or paid.
 - c. Provisions made in the statement of profit and loss in anticipation of liabilities where the relevant liabilities are allowed in subsequent years when they crystallize.
2. Expenses amortized for tax purposes over a period of years but are allowed in the books wholly in the first year.
 - a. preliminary expenses under section 35D
 - b. expenses incurred for amalgamation under section 35DD
 - c. prospecting expenses under section 35E.
3. Where book and tax depreciation differ.
 - a. Differences in depreciation rates.
 - b. Differences in method of depreciation e.g. SLM or WDV.
 - c. Differences in method of calculation e.g. calculation of depreciation with reference to individual assets in the books but on block basis for tax purposes
 - d. Depreciation amortized in the books over a period of years but are allowed for tax purposes wholly in the first year. E.g. machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life.
4. Where a deduction is allowed in one year for tax purposes on the basis of a deposit made under a permitted deposit scheme (e.g. tea development account scheme under section 33AB or site restoration fund scheme under section 33ABA) and expenditure out of withdrawal from such deposit is debited in the statement of profit and loss in subsequent years.

5. Income credited to the statement of profit and loss but taxed only in subsequent years e.g. conversion of capital assets into stock in trade.
6. If for any reason the recognition of income is spread over a number of years in the accounts but the income is fully taxed in the year of receipt.

Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. It is ignored as per AS-22.

EXAMPLES FOR PERMENENT DIFFERENCE:

1. Fines and penalties.
2. Agriculture income.
3. Expenses which are disallowed forever as per income tax act ex: SEC.40(A) of income tax act
4. Income taxes paid.
5. Donations not covered under sec.80G.

RECOGNITION:

1. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation.
2. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.
3. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty is not a matter of perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form.

Example:

a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party.

Re-assessment of Unrecognised Deferred Tax Assets:

At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Review of previously recognised Deferred Tax Assets:

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

MEASUREMENT:

1. Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.
2. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.
3. Deferred tax assets and liabilities should not be discounted to their present value.

Explanation:

Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.

PRESENTATION AND DISCLOSURE:

1. An enterprise should offset assets and liabilities representing current tax if the enterprise:
 - a. Has a legally enforceable right to set off the recognised amounts; and
 - b. Intends to settle the asset and the liability on a net basis.

2. An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.
3. An enterprise should offset deferred tax assets and deferred tax liabilities if:
 - a. The enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and
 - b. The deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.
4. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B (OR) 80-IA and 80-IB of the Income Tax Act, 1961:

1. The deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Act OR to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of sections 80-IA and 80-IB of the Act.
2. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate.
3. For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the context of section 115JB(MAT) of the Income Tax Act, 1961:

1. The payment of tax under section 115JB of the Act is a current tax for the period.
2. In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

3. In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

CA SATYA RAJU

PROBLEMS FOR DISCUSSION

PROBLEM1:

A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 20X1, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs. 2,00,000 each year and the corporate tax rate is 40 per cent each year. How you present Tax expense in statement of profit & loss, Balance sheet and also provide necessary Journal entries. (Illustration-1 in AS text)

PROBLEM2:

In Problem 1, the substantively enacted tax rates for 20X1, 20X2 and 20X3 are 40%, 35% and 38% respectively. Calculate the amount of deferred tax liability at the end of all the three years?

PROBLEM 3:

Rama Ltd., has provided the following information:

Particulars	Rs.
Depreciation as per accounting records	2,00,000
Depreciation as per income tax records	5,00,000
Unamortised preliminary expenses as per tax records	30,000

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

PROBLEM 4:

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of Rs. 2,00,000 for the year ending 31.3.20X1. For the years ending 31.3.20X2 and 31.3.20X3, it made profits of Rs. 1,00,000 and Rs. 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.20X1, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the

years ending 20X2 and 20X3 for tax purposes. Prepare a statement of Profit and Loss for the years ending 20X1, 20X2 and 20X3. (SM)

PROBLEM 5:

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statements during 20X0-20X1, 20X1-20X2 and 20X2-20X3 for Rs. 11,00,000, Rs. 16,00,000 and Rs. 21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognised revenue of Rs. 7,00,000, Rs. 18,00,000 and Rs. 23,00,000 for the years 20X0-20X1, 20X1-20X2 and 20X2-20X3 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 20X0-20X1, 20X1- 20X2 and 20X2-20X3. (SM)

PROBLEM 6:

From the following details of A Ltd. for the year ended 31-03-20X1, calculate the deferred tax asset/liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Particulars	Rs.
Accounting profit	6,00,000
Book profit as per MAT	3,50,000
Profit as per income tax Act	60,000
Tax rate	20%
MAT rate	7.50%

(SM)

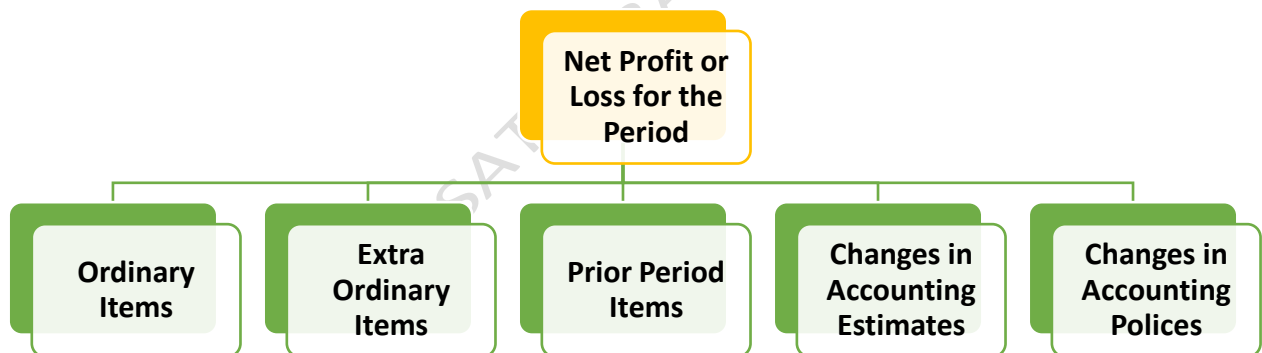
PROBLEM 7:

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

2(D).AS-5 NET PROFIT OR LOSS FOR PERIOD, PRIOR PERIOD ITEMS AND CHANGE IN ACCOUNTING POLICIES

OBJECTIVE:

1. The objective of this Standard is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises.
2. This Standard should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.



SCOPE:

This Standard does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Net Profit or Loss for the Period:

1. 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.
2. 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.

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. No separate disclosure required for ordinary activities.

EXCEPTIONAL ITEMS: When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

EXAMPLES:

1. The write-down of inventories to net realisable value as well as the reversal of such write-downs
2. A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring
3. Disposals of items of fixed assets
4. Disposals of long-term investments
5. Legislative changes having retrospective application
6. Litigation settlements
7. Other reversals of provisions

EXTRAORDINARY ITEMS:

1. Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.
2. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.
3. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

EXAMPLES:

1. Attachment of property of the enterprise
2. An earthquake & Natural calamities
3. Refund of Government grant. Etc
4. Government grant receivable as compensation for expenses incurred in previous accounting period

PRIOR PERIOD ITEMS:

1. 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.
2. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, mis-interpretation of facts, or oversight.
3. 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.
4. Prior period items will disclose in the statement of profit and loss after determination of current net profit or loss.

CHANGES IN ACCOUNTING ESTIMATES:

1. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets etc.
2. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. i.e It is accounted Prospectively.
3. As per AS 10 (Revised), Property, Plant and Equipment, residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change should be accounted for as a change in an accounting estimate in accordance with AS 5
4. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:
 - a. The period of the change, if the change affects the period only; or

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

Example:

a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset.

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

CHANGES IN ACCOUNTING POLICIES:

- 1. 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.
- 2. Accounting Policies can be changed only:
 - a. When the adoption of a different accounting policy is required by statute; or
 - b. For compliance with an Accounting Standard; or
 - c. When it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.
- 3. The following are not changes in accounting policies:
 - a. The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement;
 - b. The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial. E.g., Announcement of pension in the organisation for Employees after retirement but earlier there was no such scheme of pension in the organisation.
- 4. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial

statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated.

5. 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.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

State whether the following items are examples of change in Accounting Policy / Change in Accounting Estimates / Extraordinary items / Prior period items / Ordinary Activity:

1. Actual bad debts turning out to be more than provisions.
2. Change from Cost model to Revaluation model for measurement of carrying amount of PPE.
3. Government grant receivable as compensation for expenses incurred in previous accounting period.
4. Treating operating lease as finance lease.
5. Capitalisation of borrowing cost on working capital.
6. Legislative changes having long term retrospective application.
7. Change in the method of depreciation from straight line to WDV.
8. Government grant becoming refundable.
9. Applying 10% depreciation instead of 15% on furniture.
10. Change in useful life of fixed assets.

(JAN 2021 -QP-1(b))

PROBLEM 2:

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of Rs. 5.30 lakhs for the period October, 20X1 to September, 20X7 has been received and paid in February, 20X8. However, the same was accounted in the year 20X8-X9. Comment on the accounting treatment done in the said case.

(SM)

PROBLEM 3:

- i. During the year 20X1-20X2, a medium size manufacturing company wrote down its inventories to net realisable value by Rs. 5,00,000. Is a separate disclosure necessary?
- ii. A company signed an agreement with the Employees Union on 1.10.20X2 for revision of wages with retrospective effect from 30.9.20X1. This would cost the company an additional liability of Rs. 5,00,000 per annum. Is a disclosure necessary for the amount paid in 20X2-X3? **(SM)**

PROBLEM 4:

The company finds that the inventory sheets of 31.3.20X1 did not include two pages containing details of inventory worth Rs. 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 20X2. **(SM)**

PROBLEM 5:

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

- i. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.
- ii. Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of Rs. 20,000 per month. Earlier there was no such scheme of pension in the organisation. **(SM)**

PROBLEM 6:

There was a major theft of stores valued at Rs. 10 lakhs in the preceding year which was detected only during current financial year (2020-2021). How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2021. **(RTP-NOV 2021-13(a))**

2(E).AS 9 REVENUE RECOGNITION

INTRODUCTION:

This Standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

1. the sale of goods,
2. the rendering of services, and
3. the use by others of enterprise resources yielding interest, royalties and dividends.

SCOPE:

This Standard does not deal with the following aspects of revenue recognition.

1. Revenue arising from construction contracts
2. Revenue arising from hire-purchase, lease agreements;
3. Revenue arising from government grants and other similar subsidies;
4. Revenue of insurance companies arising from insurance contracts.

REVENUE DEFINITION:

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.

Items not included within the definition of 'Revenue':

1. Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
2. Realised gains resulting from the discharge of an obligation at less than its carrying amount;
3. Unrealised gains resulting from the restatement of the carrying amount of an obligation.
4. Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

NOTE:

1. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.
2. Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

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

SALE OF GOODS:

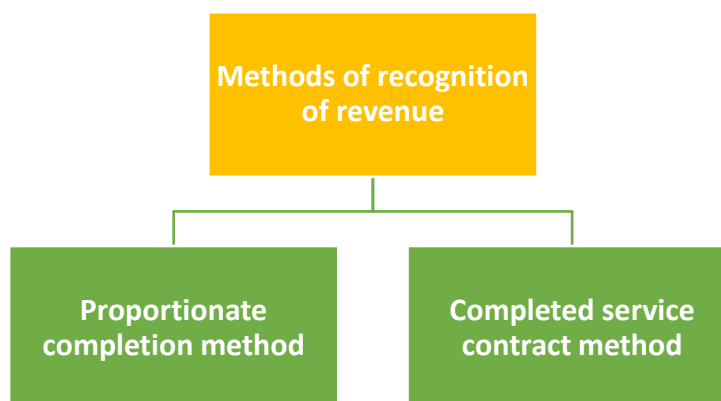
Revenue from sales transactions should be recognised when the requirements as to performance are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

Performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) the seller of goods has transferred to the buyer the property in the goods for a price
- (ii) all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- (iii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

RENDERING OF SERVICES:

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transactions.



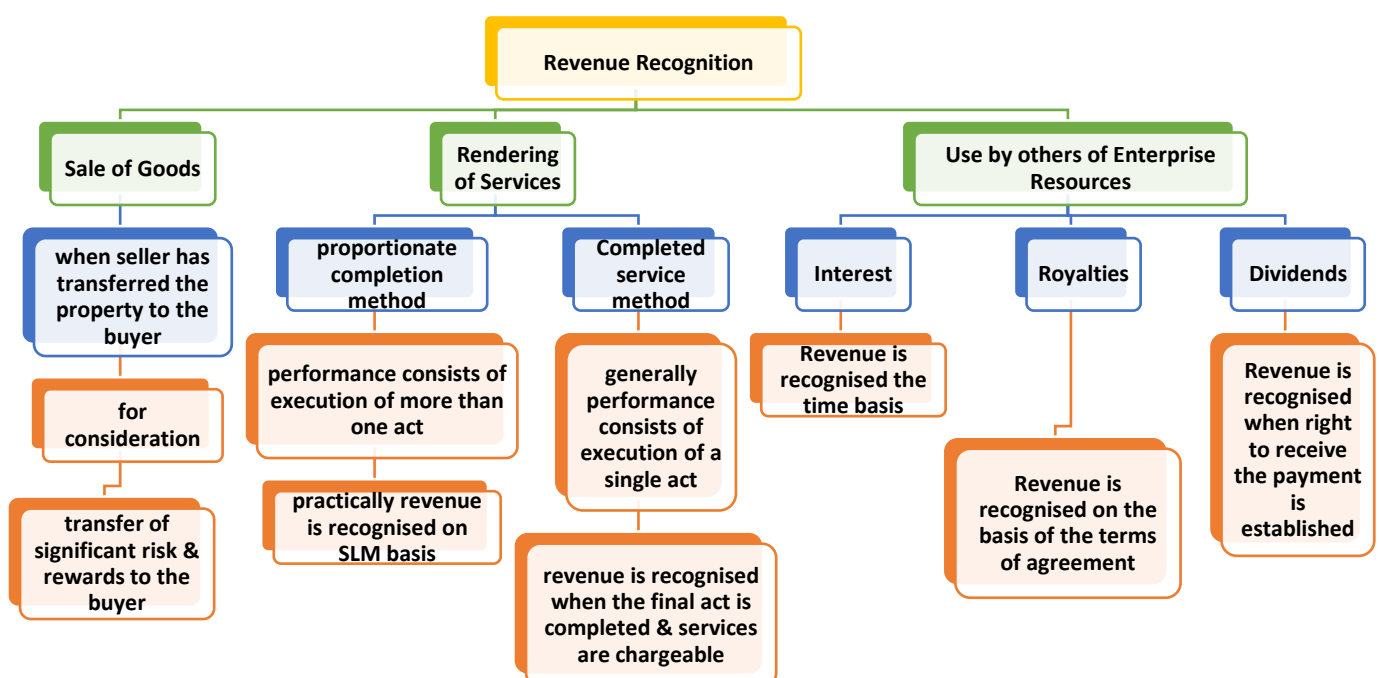
1. **Proportionate Completion Method** is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.
2. **Completed Service Contract Method** is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act e.g. installation of a machine, or repair service.

Income from other sources - Interest, Royalties and Dividends

1. **Interest**: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognised on a time proportion basis taking into account the amount outstanding and the rate applicable.
2. **Royalties**: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.
3. **Dividends**: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

NOTE:

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognized when no significant uncertainty as to measurability or collectability exists.



Effect of Uncertainties on Revenue Recognition:

1. 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.
2. When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.
3. An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

Disclosure: An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

REVENUE RECOGNITION - DIFFERENT CASES:

1. Sale of Goods

A. In case of Sale of Goods Delivery is delayed at buyer's request and buyer takes title and accepts billing

Revenue should be recognised at the time of sale provided items must be on hand, identified and ready for delivery to the buyer.

B. Goods are sold subject to installation, inspection etc

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory tested television receiver normally only requires unpacking and connecting of power and antennae).

C. SALE OF GOODS ON APPROVAL BASIS:

Revenue should not be recognised until the goods have been formally accepted by the buyer or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

D. cash on delivery sales:

Revenue should not be recognised until cash is received by the seller or his agent.

E. consignment sales:

Revenue should not be recognised until the goods are sold to a third party.

F. Guaranteed sales i.e. delivery is made 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.

G. Special order and shipment:

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

H. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date

Such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue for both the parties. The resultant difference between sale price and Re-purchase price is treated as interest and recognised on the basis of time proportion in later party books.

I. Subscriptions for publications

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where 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 value of all items covered by the subscription.

J. Instalment sales

When the consideration is receivable in instalments, revenue attributable to the sales 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.

2. Rendering of Services

A. Installation Fees

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

B. Advertising agency commission

Advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed.

C. Insurance agency commission

Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

D. Admission fees

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

E. Tuition fees

Revenue should be recognised over the period of instruction.

F. Entrance and membership fees

Revenue recognition from these sources will depend on 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 fee 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.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

The Board of Directors decided on 31.3.20X2 to increase the sale price of certain items retrospectively from 1st January, 20X2. In view of this price revision with effect from 1st January 20X2, the company has to receive Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2. Accountant cannot make up his mind whether to include Rs. 15 lakhs in the sales for 20X1-20X2. Advise. (SM)

PROBLEM 2:

Y Ltd., used certain resources of X Ltd. In return X Ltd. received Rs. 10 lakhs and Rs. 15 lakhs as interest and royalties respectively from Y Ltd. during the year 20X1-X2. You are required to state whether and on what basis these revenues can be recognized by X Ltd. (SM)

PROBLEM 3:

A claim lodged with the Railways in March, 20X1 for loss of goods of Rs. 2,00,000 had been passed for payment in March, 20X3 for Rs. 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 20X3. (SM)

PROBLEM 4:

In the year 20X1-X2, XYZ supplied goods on Consignment basis to ABC – a retail outlet worth Rs. 10,00,000. As per the terms, ABC will only pay XYZ for the goods which are sold by them to the third party. Rest of the goods can be returned back to XYZ and ABC will not have any further liability for these goods. During the year 20X1-X2, ABC has sold goods worth Rs. 5,50,000 only and rest of the goods are still lying in its store which may get sold by next year. Advise XYZ, how much revenue it can recognize in its books for period 20X1-X2. (SM)

PROBLEM 5:

A Ltd. has sold its building for Rs. 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is Rs. 30 lakhs. As on 31st March, 20X1, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment? (SM)

PROBLEM 6:

The following information of Meghna Ltd. is provided:

1. Goods of Rs. 60,000 were sold on 20-3-20X2 but at the request of the buyer these were delivered on 10-4-20X2.
2. On 15-1-20X2 goods of Rs. 1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-3-20X2
3. Rs. 1,20,000 worth of goods were sold on approval basis on 1-12-20X1. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-20X2 and no approval or disapproval received for the remaining goods till 31-3-20X2.
4. Apart from the above, the company has made cash sales of Rs. 7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.

You are required to advise the accountant of Meghna Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS 9. **(SM)**

PROBLEM 7:

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

(RTP-NOV 2021-15(b))

PROBLEM 8:

Fashion Limited is engaged in manufacturing of readymade garments. They provide you the following information on 31st March, 2019:

- (i) On 15th January, 2019 garments worth Rs. 4,00,000 were sent to Anand on consignment basis of which 25% garments unsold were lying with Anand as on 31st March, 2019.
- (ii) Garments worth Rs. 1,95,000 were sold to Shine boutique on 25th March, 2019 but at the request of Shine Boutique, these were delivered on 15th April, 2019.

You are required to advise the accountant of Fashion Limited, the amount to be recognised as revenue in above cases in the context of AS 9. **(RTP-NOV 2020-14(a))**

PROBLEM 9:

Indicate in each case whether revenue can be recognized and when it will be recognized as per AS-9.

- (1) Trade discount and volume rebate received.
- (2) Where goods are sold to distributors or others for resale.
- (3) Where seller concurrently agrees to repurchase the same goods at a later date.
- (4) Insurance agency commission for rendering services.
- (5) On 11-03-2019 cloths worth Rs. 50,000 were sold to X mart, but due to refurbishing of their showroom being underway, on their request, clothes were delivered on 12-04-2019.

(EXAM QP-NOV 2019-1(C))

CA SATYA RAJU

2(F) AS 7 CONSTRUCTION CONTRACTS

OBJECTIVE:

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. The primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed.

SCOPE:

This Standard should be applied in accounting for construction contracts in the financial statements of contractors.

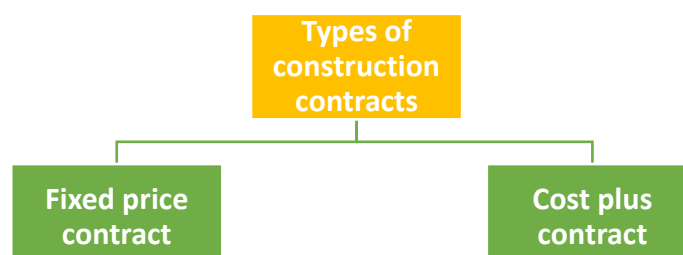
DEFINITIONS:

construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

NOTES:

1. A construction contract may be the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.
2. **For the purposes of this Standard, construction contracts also include:**
 - (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
 - (b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

TYPES OF CONSTRUCTION CONTRACTS:



Fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

Percentage Completion Method:

1. Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year. This method of accounting, called the stage of completion method.
2. AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract.
 - A. The outcome of fixed price contracts can be estimated reliably when all the following conditions are satisfied:
 - i. Total contract revenue can be measured reliably;
 - ii. It is probable that the economic benefits associated with the contract will flow to the enterprise;
 - iii. Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
 - iv. The contract costs attributable to the contract can be clearly identified and measured reliably.
 - B. The outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:
 - i. It is probable that the economic benefits associated with the contract will flow to the enterprise; and
 - ii. The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

3. AS 7 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:
 1. Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
 2. Contract costs should be recognised as an expense in the period in which they are incurred.
4. When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method.

METHODS USED FOR PERCENTAGE OF COMPLETION:

1. The proportion that contract costs incurred for work performed up to the reporting date bear to the estimated total contract costs; or
2. Surveys of work performed; or
3. Completion of a physical proportion of the contract work.

CONTRACT REVENUE:

Contract revenue should comprise:

1. The initial amount of revenue agreed in the contract; and
2. Variations in contract work,

A variation is included in contract revenue when:

- a. It is probable that the customer will approve the variation and the amount of revenue arising from the variation; and
- b. The amount of revenue can be reliably measured.

3. claims

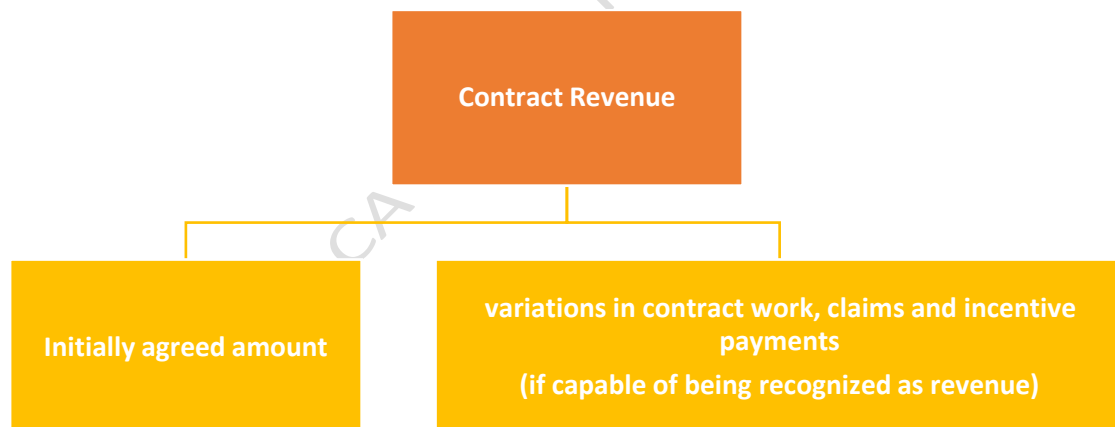
- a. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work.
- b. Claims are only included in contract revenue when:

- i. Negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and
- ii. The amount that it is probable will be accepted by the customer can be measured reliably.

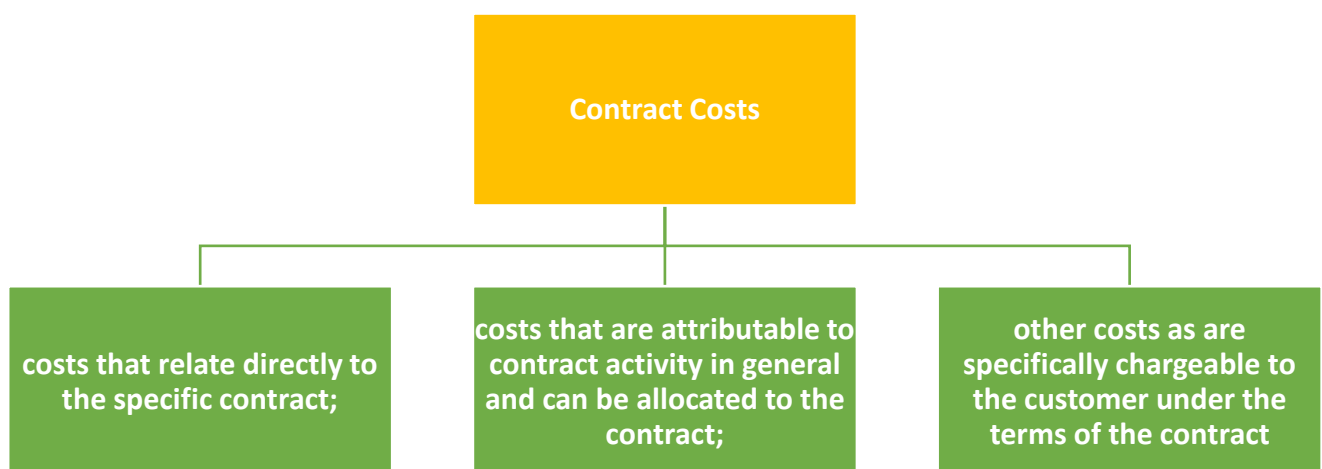
4. Incentive payments:

- a. Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract.
- b. Incentive payments are included in contract revenue when:
 - i. The contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
 - ii. The amount of the incentive payment can be measured reliably

5. Penalties.



CONTRACT COSTS:



Examples of costs that relate directly to a specific contract include:

1. site labour costs, including site supervision
2. costs of materials used in construction
3. depreciation of plant and equipment used on the contract
4. costs of moving plant, equipment and materials to and from the contract site
5. costs of hiring plant and equipment

Example of costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

1. Insurance
2. Costs of design and technical assistance that is not directly related to a specific contract
3. Construction overheads.

Examples of costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

1. General administration costs for which reimbursement is not specified in the contract
2. Selling costs
3. Research and development costs for which reimbursement is not specified in the contract
4. Depreciation of idle plant and equipment that is not used on a particular contract

Treatment of Costs Relating to Future Activity

A contractor may have incurred contract costs that relate to future activity on the contract. Such expenses are excluded from contract cost related to current year and recognised as an asset provided it is probable that they will be recovered.

Examples of contract costs which are excluded are:

1. contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance.
2. Payments made to subcontractors in advance of work performed under the subcontract.

Recognition of Expected Losses

When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

The amount of such a loss is determined irrespective of:

1. Whether or not work has commenced on the contract;
2. The stage of completion of contract activity; or
3. The amount of profits expected to arise on other contracts.

Uncollectable Contract Revenue:

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

Combining and Segmenting Construction Contracts

The standard identifies certain cases where for the purposes of accounting, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract.

1. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:
 - a. Separate proposals have been submitted for each asset;
 - b. Each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
 - c. The costs and revenues of each asset can be identified.
2. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
 - a. The group of contracts is negotiated as a single package;
 - b. The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - c. The contracts are performed concurrently or in a continuous sequence.
3. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:
 - a. The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
 - b. The price of the asset is negotiated without regard to the original contract price.

DISCLOSURES:**1. An enterprise should disclose:**

- a. The amount of contract revenue recognised as revenue in the period;
- b. The methods used to determine the contract revenue recognised in the period; and
- c. The methods used to determine the stage of completion of contracts in progress.

2. An enterprise should disclose following in respect of contracts in progress at the reporting date:

- a. The aggregate amount of costs incurred and recognised profits (less recognised losses) up to the reporting date;
- b. The amount of advances received; and
- c. The amount of retentions.
 - **Retentions** are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.
 - **Progress billings** are amounts billed for work performed on a contract whether or not they have been paid by the customer.
 - **Advances** are amounts received by the contractor before the related work is performed.

d. An enterprise should also present:

- The gross amount due from customers for contract work as an asset; and
- The gross amount due to customers for contract work as a liability.

Particulars	Rs.
Costs incurred	xxx
Plus: Recognised profits	xxx
Less: Recognised losses	xxx
Less: Progress billings	xxx
Amount	xxx

If above amount is **positive**- Gross amount due from customers

If above amount is **negative**- Gross amount due to customers

PROBLEMS FOR DISCUSSION

PROBLEM 1:

A construction contractor has a fixed price contract for Rs. 9,000 lacs to build a bridge in 3 years time frame. A summary of some of the financial data is as under:

PARTICULARS	(Amount Rs. in lacs)		
	Year1	Year 2	Year 3
Initial Amount for revenue agreed in contract	9,000	9,000	9,000
Variation in Revenue (+)	-	200	200
Contracts costs incurred up to the reporting date	2,093	6,168*	8,100**
Estimated profit for whole contract	950	1,000	1,000

*Includes Rs. 100 lacs for standard materials stored at the site to be used in year 3 to complete the work.

**Excludes Rs. 100 lacs for standard material brought forward from year 2.

The variation in cost and revenue in year 2 has been approved by customer. Compute year wise amount of revenue, expenses, contract cost to complete and profit or loss to be recognized in the Statement of Profit and Loss as per AS-7 (revised). (SM)

PROBLEM 2:

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.

	RS.000
Contract price fixed	600
Cost incurred to date	390
Estimated cost to complete	260

(SM)

PROBLEM 3:

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March 20X1.

Particulars	(Rs. in lakhs)
-------------	----------------

Total contract price	1,000
Work certified for the cost incurred	500
Work not yet certified for the cost incurred	105
Estimated further cost to completion	495
Progress payments received	400
To be received	140

The firm seeks your advice in view the requirements of AS 7 on below.

- (a) Percentage of completion
- (b) Contract revenue to be recognized.
- (c) profit/loss for the period
- (d) Amount due from/to customers
- (e) Relevant Disclosures

(SM-ILLUSTRATION-1)

PROBLEM 4:

On 1st December, 20X1, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 20X2, the company found that it had already spent Rs. 64,99,000 on the construction. Prudent estimate of additional cost for completion was Rs. 32,01,000. What amount should be recognized in the statement of profit and loss for the year ended 31st March, 20X2 as per provisions of Accounting Standard 7 (Revised)?

(SM)

PROBLEM 5:

Akar Ltd. Signed on 01/04/X1, a construction contract for Rs. 1,50,00,000. Following particulars are extracted in respect of contract, for the year ended 31/03/X2.

- Materials used Rs. 71,00,000
- Labour charges paid Rs. 36,00,000
- Hire charges of plant Rs. 10,00,000
- Other contract cost incurred Rs. 15,00,000
- Labour charges of Rs. 2,00,000 are still outstanding on 31.3.X2.
- It is estimated that by spending further Rs. 33,50,000 the work can be completed in all respect.

You are required to compute profit/loss for the year to be taken to Profit & Loss Account and any provision for foreseeable loss to be recognized as per AS 7.

(SM)

PROBLEM 6:

ABC Ltd., a construction contractor, undertakes the construction of commercial complex for XYZ Ltd. ABC Ltd. submitted separate proposals for each of 3 units of commercial complex. A single agreement is entered into between the two parties. The agreement lays down the value of each of the 3 units i.e. Rs. 50 lakh, Rs. 60 lakh and Rs. 75 lakh respectively. Agreement also lays down the completion time for each unit. Comment, with reference to AS 7, whether ABC Ltd., should treat it as a single contract or three separate contracts.

(RTP-MAY 2021-13(b))

PROBLEM 7:

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 Rs. 2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily. Is X correct in his proposal? Discuss.

(RTP-NOV 2021-14(b))

PROBLEM 8:

The following data is provided for M/s. Raj Construction Co.

1. Contract Price - Rs. 85 lakhs
2. Materials issued - Rs. 21 Lakhs out of which Materials costing Rs. 4 Lakhs is still lying unused at the end of the period.
3. Labour Expenses for workers engaged at site - Rs. 16 Lakhs (out of which Rs. 1 Lakh is still unpaid)
4. Specific Contract Costs - Rs. 5 Lakhs
5. Sub-Contract Costs for work executed - Rs. 7 Lakhs, Advances paid to sub-contractors - Rs. 4 Lakhs
6. Further Cost estimated to be incurred to complete the contract - Rs. 35 Lakhs

You are required to compute the Percentage of Completion, the Contract Revenue and Cost to be recognized as per AS-7.

(QP-JULY 2021-1(a))

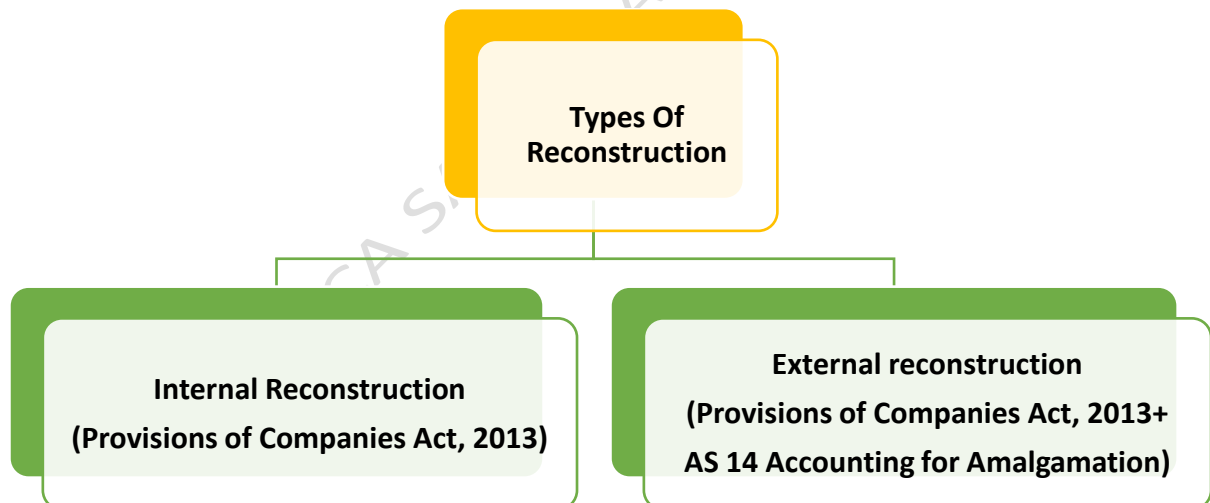
3.AMALGAMATION OF COMPANIES+AS-14

INTRODUCTION:

1. MEANING OF RECONSTRUCTION:

When a company has been making losses for several years, the financial position does not present a true and fair view of the state of the affairs of the company. In such a company the assets are generally overvalued, as the balance sheet consists of fictitious assets, unrepresented intangible assets and debit balance in the profit and loss account (showing the carry forward of losses). Such a situation always leads the company to show a higher net worth and not depicting a true picture of financial statements. In short, the company is over capitalized. Such a situation brings the need for reconstruction/reorganization of the affairs.

2. TYPES OF RECONSTRUCTION:



INTERNAL RECONSTRUCTION:

It is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered, by reducing the paid-up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganize capital or to compound with creditors, so that company can be bailed out from present situation without winding up the existing company.

EXTERNAL RECONSTRUCTION:

It is an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its

being continued by the transferee company. Such external reconstruction is essentially covered under the category of 'amalgamation in the nature of merger' in AS 14.

3. Difference Between Internal and External Reconstruction:

Basis	Internal Reconstruction	External Reconstruction
Liquidation and formation of new company	The existing company is not liquidated rather the capital and debt structure is changed to bring the company back to normalcy	The existing company is liquidated to form a new company in which the existing shareholders become shareholders of new company as well
Reduction of capital and varying rights	There is certain reduction of capital and sometimes the outside liabilities like debenture holders may have to reduce their claim in this scheme.	There is no reduction of capital. In fact, there is a fresh share capital of the company. The shareholders need not vary their rights in company
Legal position	Internal reconstruction is done as per provisions of section 61 and 66 of the Companies Act, 2013.	External reconstruction is regulated by section 232 of the Companies Act, 2013.
Legal formalities	It requires court's confirmation and other legal procedures before it can be implemented	It can be affected without the court's interference and less time-consuming process.

MEANING OF AMALGAMATION:

1. Amalgamation refers to the process of merger of two or more companies into a single entity or where one company takes over the other by outright purchase.
2. The term 'amalgamation' contemplates two kinds of activities:
 - a. Two or more companies join to form a new company or
 - b. Absorption and blending of one by the other.

3. This arrangement is sought by companies to receive various advantages such as economies of large-scale production, avoiding competition, increasing efficiency, expansion, increase in market share, etc
4. In amalgamation we have generally two companies called as –
 - a. Vendor or Transferor Company and
 - b. Vendee or Transferee Company.
5. Let us understand the concepts through the following examples

Example 1- Company A and Company B amalgamate to form Company C. Company A and Co B are called transferor companies and Company C is called as the transferee company- this strategy is called as AMALGAMATION.

Example 2- Company A is taken over by Company B (purchased). Here, Company A is called as Transferor Company and Company B is Transferee Company. This strategy is called as ABSORPTION.

Example 3- Company A has been suffering from losses for past 5 years, a new Company B is floated to take over the existing Company A. Here, Company A is the transferor company and Company B is Transferee Company. This strategy is termed as EXTERNAL RECONSTRUCTION.

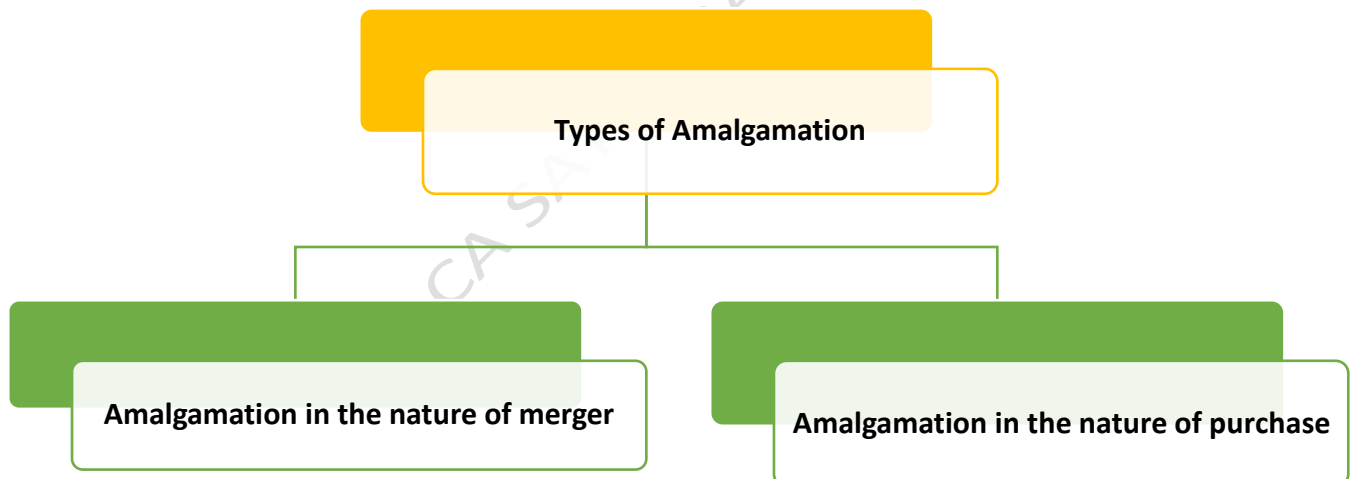
DIFFERENCE AMONG AMALGAMATION, ABSORPTION AND EXTERNAL RECONSTRUCTION:

Basis	Amalgamation	Absorption	External Reconstruction
Meaning	Two or more companies are wound up and a new company is formed to take over their business.	In this case an existing company takes over the business of one or more existing companies.	In this case, a newly formed company takes over the business of an existing company .
Minimum Number of companies involved	At least three companies are involved	At least two companies are involved	Only two companies are involved

Number of new resultant companies	Only one resultant company is formed. Two companies are wound up to form a single resultant company.	No new resultant company is formed.	Only one resultant company is formed. Under this case a newly formed company takes over the business of an existing company.
Objective	Amalgamation is done to cut competition & reap the economies in large scale.	Absorption is done to cut competition & reap the economies in large scale.	External reconstruction is done to reorganize the financial structure of the company.

TYPES OF AMALGAMATION:

- As per AS 14- "ACCOUNTING FOR AMALGAMATION", Amalgamation is of 2 types.



- Amalgamation in the nature of merger** is an amalgamation where there is a genuine pooling not only of assets and liabilities of the transferor and transferee companies but also of the shareholders' interests and of the businesses of the companies.

Amalgamation in the nature of merger is an amalgamation, which satisfies all the following conditions:

- All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- 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.

- c. 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.
- d. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- e. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies. For example, if transferor company is following weighted average method for inventory valuation, the book value of the inventory of the transferor company will be revised by applying the FIFO method (if the transferee company follows FIFO method for inventory valuation).

3. Amalgamation in the nature of purchase:

If any one or more of the above conditions are not satisfied in an amalgamation, such amalgamation is called amalgamation in the nature of purchase.

Difference between amalgamation in the nature of merger and amalgamation in the nature of purchase

Best of Distinction	Amalgamation in the Nature of Merger	Amalgamation in the Nature of Purchase
(a) Transfer of Assets and Liabilities	There is transfer of all assets & liabilities.	There need not be transfer for all assets & liabilities.
(b) Shareholders of transferor company	Equity shareholders holding 90% equity shares in transferor company become shareholders of transferee company.	Equity shareholders need not become shareholders of transferee company.

(c) Purchase Consideration	Purchase consideration is discharged wholly by issue of equity shares of transferee company (except cash only for fractional shares)	Purchase consideration need not be discharged wholly by issue of equity shares.
(d) Same Business	The same business of the transferor company is intended to be carried on by the transferee company.	The business of the transferor company need not be intended to be carried on by the transferee company.
Recording of Assets & Liabilities	The assets & liabilities taken over are recorded at their existing carrying amounts except where adjustment is required to ensure uniformity of accounting policies.	The assets & liabilities taken over are recorded at their existing carrying amounts or the basis of their fair values.
(f) Method of Accounting	Journal entries for recording the merger are passed by pooling of interest method.	Journal entries for recording the purchase of business are passed by purchase method.

PROBLEMATIC TOPICS

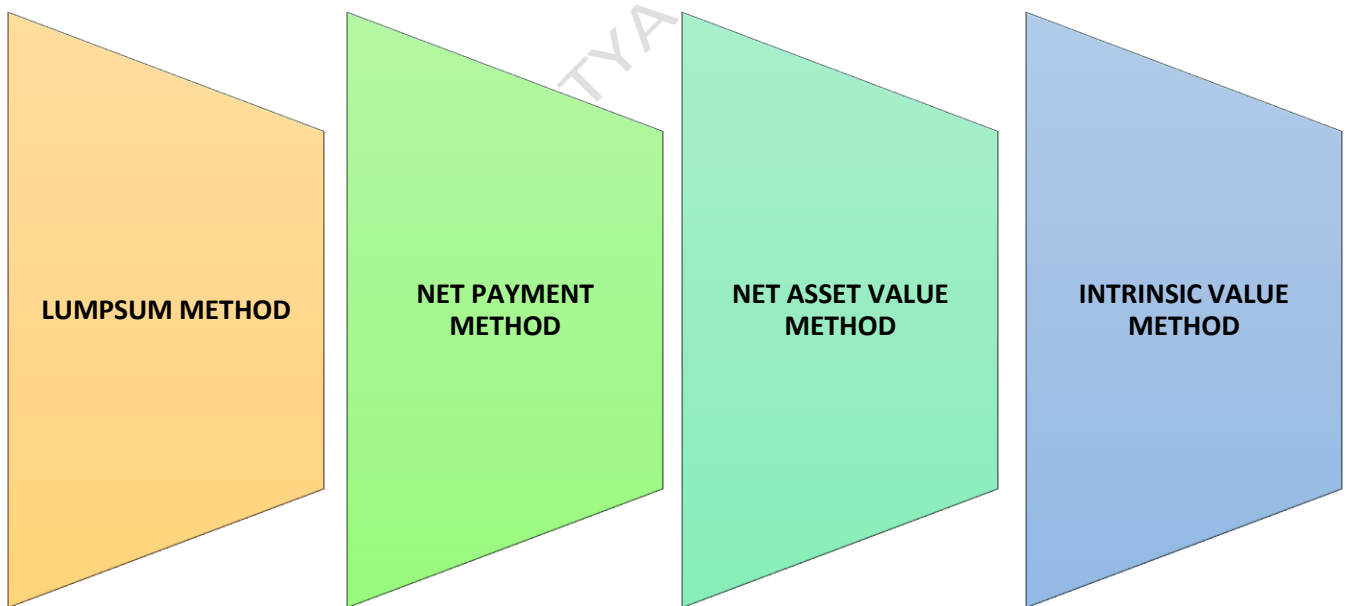
CALCULATION OF
PURCHASE
CONSIDERATION

ACCOUNTING
TREATMENT IN THE
BOOKS OF VENDOR
COMPANY

ACCOUNTING
TREATMENT IN THE
BOOKS OF PURCHASING
COMPANY

PURCHASE CONSIDERATION:

1. As per AS-14, Purchase consideration is 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”.
2. In simple words, it is the price payable by the transferee company to the transferor company for taking over the business of the transferor company.
3. The important point to be noted here is the amount paid towards the equity shareholders and preference shareholders is only considered as part of the purchase consideration as per the definition under AS-14. Hence, it should be noted that purchase consideration does not include the sum which the transferee company will directly pay to the debenture-holders or creditors of the transferor company.

METHODS OF PURCHASE CONSIDERATION:**1. LUMP SUM METHOD:**

Under this method, the transferee company agrees to pay a lumpsum/fixed amount to shareholders of the transferor company.

2. NET PAYMENT METHOD:

Under this method the transferee company makes individual payments to the equity shareholders and preference shareholders either by way of cash, issue of shares and debentures etc.

3. NET ASSET VALUE METHOD:

Under this method, the purchase consideration is arrived based on the value of the Assets less the outside liabilities (excluding share capital and reserves) taken over by the transferee company. As

per AS 14, the value of the assets and liabilities shall be at the value as agreed between the two parties. If there is no value agreed, then assets and liabilities taken at the book value.

4. **INTRINSIC VALUE METHOD:**

Under this method, the purchase consideration is calculated at the intrinsic value of shares of the transferor company.

Purchase consideration= Number of shares in transferor co. x Intrinsic value per share in transferor co.

➤ **Number of shares issued as Purchase consideration by transferee company**

Number of shares in transferor co. x Intrinsic value per share in transferor co.
Intrinsic value per share in transferee co.

NOTE: Any of the methods or a combination of the above methods can be used by the companies to calculate the purchase consideration.

Meaning of purchase consideration recorded at par value:

1. In generally purchase consideration will be recorded at Issue value.

I.e **Number of shares issued as P.C x Issue price per share**

2. If Management decide to record P.C at par value, then

Purchase consideration= Number of shares issued as P.C x Face value per share

ACCOUNTING TREATMENT IN THE BOOKS OF VENDOR COMPANY:

1. AS-14 is not applicable for Accounting in Vendor company. To close the books of selling company during the process of Amalgamation we will apply General Accounting principles related to closure of Books of Accounts.

2. **FIVE STEP APPROACH:**

STEP1: DISMANTLING OF BALANCE SHEET

- a. All Assets and Liabilities which are taken over by purchasing company will be closed and transferred to Realization a/c at book values.
- b. If any particular Asset or Liability which is not taken over by purchasing company, opened separately for the purpose of realization in outside market.
- c. Preference share capital will be transferred to Preference shareholders a/c.
- d. Equity share capital, Reserves & Surplus, Fictious Assets transferred to Equity shareholders a/c.

STEP 2: PURCHASE CONSIDERATION DUE

- a. Calculate Purchase consideration by providing separate working note.
- b. With the amount of Purchase consideration Debit the Purchasing company a/c and Credit the Realization a/c.

STEP3: PURCHASE CONSIDERATION RECEIVED

Purchasing Co. A/c will be closed by debiting the Equity shares of Purchasing co., Preference shares of purchasing co., Debentures of purchasing co., Cash etc.

STEP4: DISTRIBUTION OF PURCHASE CONSIDERATION

- a. Dispose those assets which are not taken over by the purchasing company in out side market and any profit or loss derived transferred to Realization a/c.
- b. With the available cash and P.c received by the Transferor co. will be distributed among various parties in particular order decided by Liquidation provisions.
 - (i) Realization expenses/Liquidation expenses
 - (ii) Secured creditors
 - (iii) Un secured creditors
 - (iv) Preference shareholders
 - (v) Finally Equity share holders

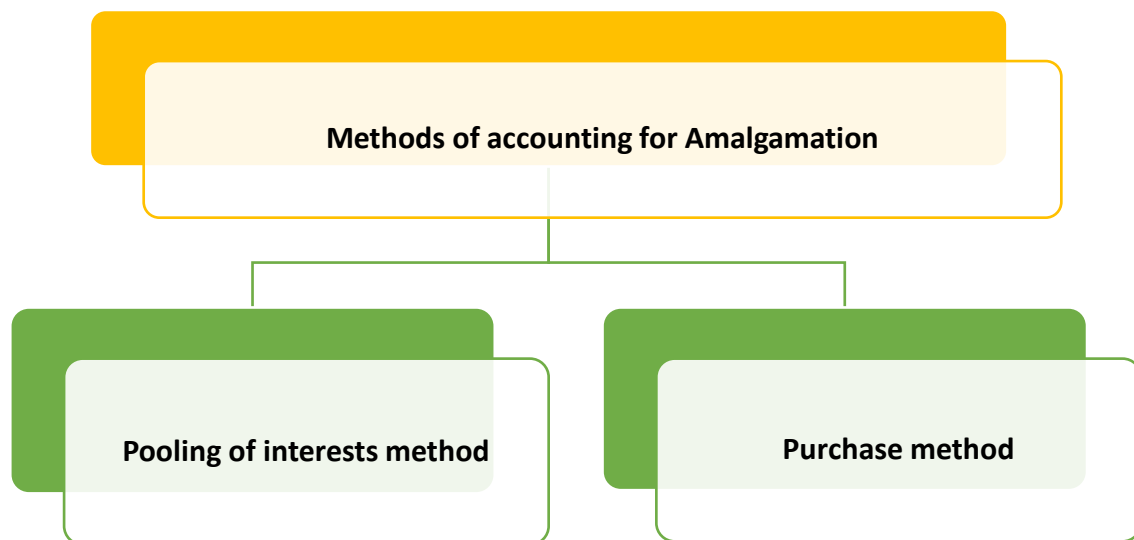
During this process of distribution any profit or loss derived will be transferred to Realization a/c.

STEP5: FINAL SETTLEMENT TO EQUITY SHARET HOLDERS

- a. Before making settlement to Equity shareholders, close Realization a/c and find Realization profit or loss. Such profit or loss will be transferred to Equity shareholders a/c.
- b. All the remaining Resources in selling company just distribute among Equity shareholders. All accounts in Selling company will be closed with this final step.

ACCOUNTING TREATMENT IN THE BOOKS OF PURCHASING COMPANY:

There are two main methods of accounting for amalgamation in purchasing company books. The first method is used in case of amalgamation in the nature of merger where the conditions as per AS-14, required are fulfilled and the second method is used in case of amalgamation in the nature of purchase.



Pooling of Interest Method

1. Under pooling of interest method, the assets, liabilities and reserves of the Transferor Company will be taken over by Transferee Company at existing carrying amounts unless any adjustment is required due to different accounting policies followed by these companies.
2. As a result the difference between the amount recorded as share capital issued as p.c and the amount of share capital of Transferor Company should be adjusted in the reserves of the financial statements of Transferee company .i.e Recorded as deduction from the reserves where the p.c issued is more than the capital of the transferor company, Otherwise treated as capital Reserve.
3. In simple terms, where in case of pooling method- the amount to be adjusted against the reserves- can be computed in the following 3 steps

Step I- Equity Share capital + Preference share capital issued+ any other additional consideration in form of cash and other assets by the Transferee Company.

Step II- Existing Equity share capital + Existing Preference share capital in the books of Transferor Company.

Step III- Step I- Step II= amount to be adjusted from the reserves of Transferee company or Capital reserve.

Purchase Method

1. Assets and Liabilities:

The assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

2. Difference between the Purchase Consideration and Net Assets transferred:

- a. Any excess of the amount of purchase consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognized as goodwill in the financial statement of the transferee company. Any short fall should be shown as capital reserve. Goodwill should be amortized over period of five years unless a somewhat longer period can be justified.
- b. In simple terms, where in case of purchase method- the amount to be transferred to capital reserve or to be recorded as Goodwill- can be computed in the following 3 steps.

Step I- Find out the Net assets amount using the following formula- Total assets-Outside liabilities (Non-current liabilities + Current Liabilities)

Step II- Compute the purchase consideration using any of the methods as given under Purchase consideration computation.

Step III-

- a. If Step I- Step II= Positive amount- then it is capital reserve- since the assets received more than the amount paid as purchase consideration to acquire them.
- b. If Step I- Step II= Negative amount- then it is to be recorded as Goodwill (intangible asset) - since the amount paid for acquiring business is more than the Net assets, which is technically due to its goodwill.

3. Treatment of reserves under purchase method

- a. No reserves, other than statutory reserves, of the transferor company should be incorporated in the financial statements of transferee-company. The balance of Profit and Loss account, general reserves of the transferor company are not recorded at all.
- b. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made only in respect of statutory reserves and such reserves shall 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, till the time their identity is required to be maintained to comply with the relevant statute.
- c. Statutory reserves of the transferor company should be incorporated in the balance sheet of transferee company by way of the following journal entry.

Amalgamation Adjustment Reserve A/c Dr.

To Statutory Reserves

- d. 'Amalgamation Adjustment Reserve' is debited to bring in the statutory reserves of the transferor company. This is represented as deduction from the reserves of the transferee company after amalgamation. Once after the time period to show such statutory reserves is over, both the reserves and the aforesaid account are reversed.

Typical adjustments which shall be noted while working out the problems –

1. **Inter Company-owing** - Should the purchasing company owe an amount to the vendor company or vice versa, the amount will be included in the book debts of one company and trade payables of the other. This should be adjusted by the entry:

Trade payables	Dr.	XXXX	
To Trade receivables			XXXX

2. **Adjustment of the value of stock**

Inter-company owings arise usually from purchase and sale of goods; it is likely, therefore, that at the time, of the sale of business, the debtor company also has goods in stock which it purchased from the creditor company - the cost of the debtor company will include the profit made by the creditor company. After the takeover of the business it is essential that such a profit is eliminated. This should be adjusted by the entry:

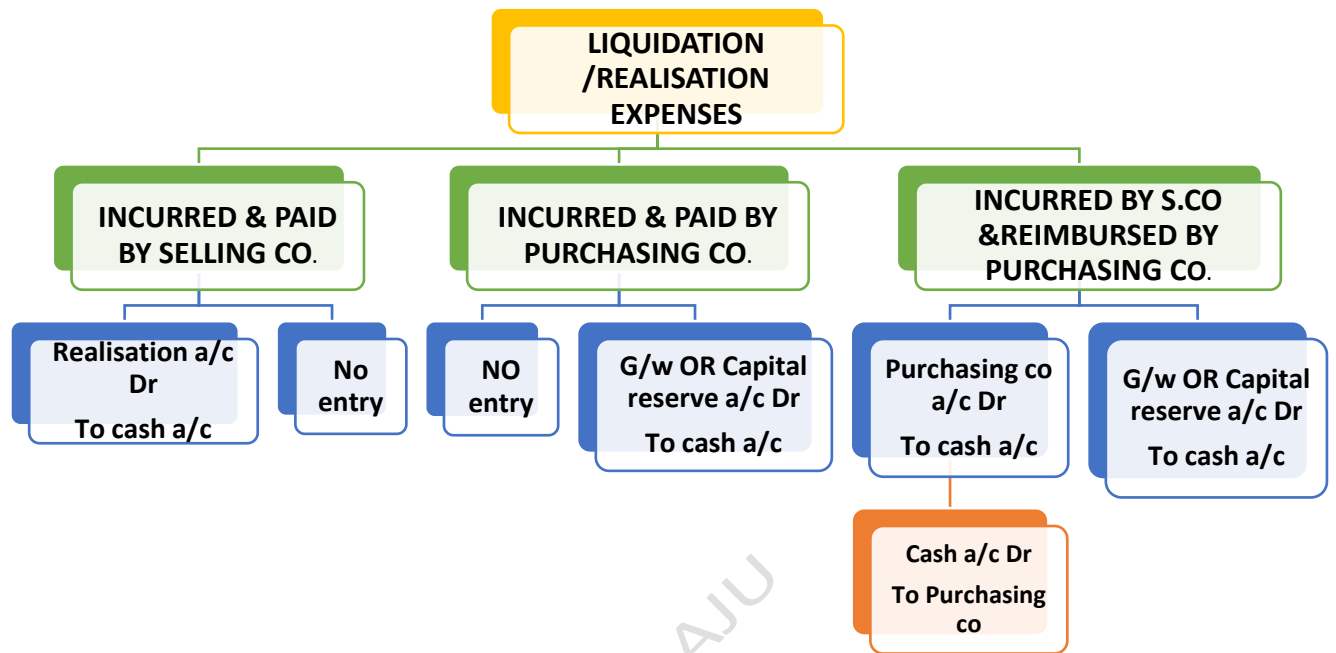
Good will/Capital reserve A/C	Dr	XXXX	
TO Stock reserve A/C			XXXX

3. **Inter-company Loans**

Where there is any loan taken by the transferor company from the transferee company then the amount of the loan shall be taken over by the transferee company and adjustment entry to be passed as follows:

Loan (liability of Transferor co) A/c	Dr	XXXX	
To Loans and advances (assets)			XXXX

4. LIQUIDATION/REALISATION EXPENSES



PROBLEMS FOR DISCUSSION

PROBLEM 1:

Wye Ltd. acquires the business of Zed Ltd. whose balance sheet as at 31st March, 20X1 is as under:

		Particulars	Notes	Rs.
		Equity and Liabilities		
1.		Shareholders' funds		
	A.	Share capital	1	12,00,000
	B.	Reserves and Surplus	2	1,58,000
2.		Non-current liabilities		
	A.	Long-term borrowings	3	2,00,000
3.		Current liabilities		
	A.	Trade Payables		1,20,000
	B.	Other current liabilities (Interest payable on debentures)		12,000
		TOTAL		<u>16,90,000</u>
		Assets		
1.		Non-current assets		
	A.	Property, Plant and Equipment	4	10,00,000
	B.	Intangible assets	5	2,90,000
2.		Current assets		
	A.	Inventories		1,50,000
	B.	Trade receivables		1,80,000
	C.	Cash and Cash equivalents		<u>70,000</u>
		TOTAL		<u>16,90,000</u>

Notes to accounts:

	Rs.
1. Share Capital	
Equity Share capital (Rs. 100 each)	8,00,000
6% Preference Share capital (Rs. 100 each)	<u>4,00,000</u>

		<u>12,00,000</u>
2.	Reserves and Surplus	
	Capital reserve	1,00,000
	Profit and loss A/c	50,000
	Workmen compensation reserve (Expected liability Rs. 5,000)	8,000
		<u>1,58,000</u>
3.	Long-term borrowings	
	6% Debentures	<u>2,00,000</u>
		<u>2,00,000</u>
4.	Property, Plant and Equipment	
	Land and Building	4,00,000
	Plant and machinery	<u>6,00,000</u>
		<u>10,00,000</u>
5.	Intangible assets	
	Goodwill	2,40,000
	Patents	<u>50,000</u>
		<u>2,90,000</u>

Wye Ltd. was to take over all assets (except cash) and liabilities (except for interest due on debentures) and to pay following amounts:

- Rs. 2,00,000 7% Debentures (Rs. 100 each) in Wye Ltd. for the existing debentures in Zed Ltd.; for the purpose, each debenture of Wye Ltd. is to be treated as worth Rs. 105.
- For each preference share in Zed Ltd. Rs. 10 in cash and one 9% preference share of Rs. 100 each in Wye Ltd.
- For each equity share in Zed Ltd. Rs. 20 in cash and one equity share in Wye Ltd. of Rs. 100 each having the market value of Rs. 140.
- Expense of liquidation of Zed Ltd. are to be reimbursed by Wye Ltd. to the extent of Rs. 10,000. Actual expenses amounted to Rs. 12,500.

Wye Ltd. valued Land and building at Rs. 5,50,000 Plant and Machinery at Rs. 6,50,000 and patents at Rs. 20,000 of Zed Ltd for the purpose of amalgamation.

Requirements:

- Calculate Purchase consideration.

(ii) Provide Journal entries in the books of Vendor co. and also provide closing Ledgers

(iii) Provide Journal entries in the books of Purchasing company.

(SM)

PROBLEM 2:

S. Ltd. is absorbed by P. Ltd. The draft balance sheet of S. Ltd. is as under:

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital:		Sundry Assets	13,00,000
2,000,7%Preference shares of Rs. 100 each (fully paid-up)	2,00,000		
5,000 Equity shares of Rs. 100 each (fully paid-up)	5,00,000		
Reserves	3,00,000		
6% Debentures	2,00,000		
Trade payables	1,00,000		
	13,00,000		13,00,000

P. Ltd. has agreed:

- To issue 9% Preference shares of Rs. 100 each, in the ratio of 3 shares of P. Ltd. for 4 preference shares in S. Ltd.
- To issue to the debenture-holders in S. Ltd. 8% Mortgage Debentures at Rs. 96 in lieu of 6% Debentures in S. Ltd. which are to be redeemed at a premium of 20%;
- To pay Rs. 20 per share in cash and to issue six equity shares of Rs. 100 each (market value of Rs. 125) in lieu of every five shares held in S. Ltd.; and
- To assume the liability to trade payables.

You are required to calculate the purchase consideration.

(SM)

PROBLEM 3:

Neel Ltd. and Gagan Ltd. amalgamated to form a new company on 1.04.2015. Following is the Draft Balance Sheet of Neel Ltd. and Gagan Ltd. as at 31.3.2015:

Liabilities	Neel	Gagan	Assets	Neel	Gagan
Capital	7,75,000	8,55,000	Plant & Machinery	4,85,000	6,14,000

Current Liabilities	6,23,500	5,57,600	Building	7,50,000	6,40,000
			Current assets	1,63,500	1,58,600
	13,98,500	14,12,600		13,98,500	14,12,600

Following are the additional information:

1. The authorised capital of the new company will be Rs. 25,00,000 divided into 1,00,000 equity shares of Rs. 25 each.
2. Liabilities of Neel Ltd. includes Rs. 50,000 due to Gagan Ltd. for the purchases made. Gagan Ltd. made a profit of 20% on sale to Neel Ltd.
3. Neel Ltd. had purchased goods costing Rs. 10,000 from Gagan Ltd. All these goods are included in the current asset of Neel Ltd. as at 31st March, 2015.
4. The assets of Neel Ltd. and Gagan Ltd. are to be revalued as under:

Particulars	Neel	Gagan
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000

5. The purchase consideration is to be discharged as under:
 - b) Issue 24,000 equity shares of Rs. 25 each fully paid up in the proportion of their profitability in the preceding 2 years.
 - c) Profits for the preceding 2 years are given below:

Particulars	Neel	Gagan
1 st year	2,62,800	2,75,125
2 nd year	2,12,200	2,49,875
Total	4,75,000	5,25,000

- d) Issue 12% preference shares of Rs. 10 each fully paid up at par to provide income equivalent to 8% return on net assets in the business as on 31.3.2015 after revaluation of assets of Neel Ltd. and Gagan Ltd. respectively.

You are required to compute the

1. Equity and preference shares issued to Neel Ltd. and Gagan Ltd.,
2. Purchase consideration.

(SM)

PROBLEM 4:

Let us consider the Balance Sheet of X Ltd. as at 31st March, 20X1:

Particulars				
		Equity and Liabilities		
1		Shareholders' funds		
	A	Share capital	1	100,00
	B	Reserves and Surplus	2	12,50
2		Non-current liabilities		
	A	Long-term borrowings	3	40,00
3		Current liabilities		
	A	Trade Payables		20.00
		Total		172,50
		Assets		
1		Non-current assets		
	A	Property, Plant and Equipment	4	105,50
	B	Non-current investments	5	5,00
2		Current assets		
	a	Inventories		23,00
	b	Trade receivables		24,00
	c	Cash and Cash equivalents		15,00
		Total		172,50

Notes to accounts

1.	Share Capital		Rs. in ('000)
	Equity share capital		75,00
	7.50,000 Equity Shares of Rs. 10 each		
	25,000 14% Preference Shares of Rs. 100 each		25,00
			100.00
2	Reserves and Surplus		12,50
	General reserve		
			12,50
3	Long-term borrowings		

	Secured		
	14% Debentures		40,00
			40,00
4	Property, plant and Equipment		50,00
	Land and Building		
	Plant and machinery		45,00
	Furniture		10.50
			105.50
5	Non-current investments		
	Investments at cost		5,00
			5.00

Other Information:

- Y Ltd. takes over X Ltd. on 10th April, 20X1.
- Debenture holders of X Ltd. are discharged by Y Ltd. at 10% premium by issuing 15% own debentures of Y Ltd.
- 14% Preference Shareholders of X Ltd. are discharged at a premium of 20% by issuing necessary number of 15% Preference Shares of Y Ltd. (Face value Rs. 100 each).
- Intrinsic value per share of X Ltd. is Rs. 20 and that of Y Ltd. Rs. 30. Y Ltd. will issue equity shares to satisfy the equity shareholders of X Ltd. on the basis of intrinsic value. However, the entry should be made at par value only. The nominal value of each equity share of Y Ltd. is Rs.10.
- Compute the purchase consideration (SM)

PROBLEM 5:

The following draft Balance Sheets are given as on 31st March, 2014:

Liabilities	(in lakhs)		Assets	(in lakhs)	
	Best Ltd	Better Ltd		Best Ltd	Better Ltd
Share Capital:			Fixed Assets	25	15
Shares of Rs. 100, each fully paid	20	10	Investments	5	-
Reserve and Surplus	10	8	Current Assets	20	5
Other Liabilities	20	2			
	50	20		50	20

The following further information is given:

- a) Better Limited issued bonus shares on 1st April, 2014, in the ratio of one share for every two held, out of Reserves and Surplus.
- b) It was agreed that Best Ltd. will take over the business of Better Ltd., on the basis of the latter's Balance Sheet, the consideration taking the form of allotment of shares in Best Ltd.
- c) The value of shares in Best Ltd. was considered to be Rs. 150 and the shares in Better Ltd. were valued at Rs. 100 after the issue of the bonus shares. The allotment of shares is to be made on the basis of these values.
- d) Liabilities of Better Ltd., included Rs. 1 lakh due to Best Ltd., for purchases from it, on which Best Ltd., made profit of 25% of the cost. The goods of Rs. 50,000 out of the said purchases, remained in stock on the date of the above Balance Sheet.

Make the closing ledger in the Books of Better Ltd. and the opening journal entries in the Books of Best Ltd., and prepare the Balance Sheet as at 1st April, 2014 after the takeover. **SM**

PROBLEM 6:

K Ltd. and L Ltd. amalgamate to form a new company LK Ltd. The financial position of these two companies on the date of amalgamation was as under:

Balance Sheet of K Ltd. And L Ltd.

			Particulars	Notes No.	K Ltd (Rs.)	L Ltd (Rs.)
			1	2	3	4
1			EQUITY AND LIABILITIES:			
			Shareholder's funds			
	a		Share capital	1	12,00,000	6,00,000
	b		Reserves and Surplus	2	3,71,375	1,97,175
2			Non-current liabilities			
	a		Long term borrowings			
			5% Debentures		2,00,000	-
			Secured loan		-	2,00,000

3		Current liabilities			
	a	Trade Payable (Creditors)		1,00,000	2,10,000
		TOTAL		18,71,375	12,07,175
1		ASSETS:			
		Non-current assets			
	a	Fixed assets			
	(i)	Tangible assets	3	11,30,000	8,20,000
	(ii)	Intangible assets	4	80,000	-
2		Current Assets			
	a	Inventories (Stock)		2,25,000	1,40,000
	b	Trade receivables (Debtors)		2,75,000	1,75,000
	c	Cash and cash equivalents	5	1,61,375	72,175
		TOTAL		18,71,375	12,07,175

Note to Accounts:

Particulars	K Ltd (Rs.)	L Ltd (Rs.)
1. Share capital		
Equity Shares of Rs.100 each	8,00,000	3,00,000
7% Preference Share of Rs.100 each	4,00,000	3,00,000
2. Reserves and Surplus		
General Reserve	-	1,00,000
Profit and Loss A/c	3,71,375	97,175
3. Tangible Assets		
Land & Building	4,50,000	3,00,000
Plant & Machinery	6,20,000	5,00,000
Furniture & Fittings	60,000	20,000
4. Intangible Assets		
Goodwill	80,000	-

5. Cash and cash equivalents		
Cash at Bank	1,20,000	55,000
Cash in hand	41,375	17,175

The terms of amalgamation are as under:

A)

1. The assumption of assets and liabilities of both the Companies
2. Issue of 5 Preference shares of Rs.20 each in LK Ltd @ Rs.18 paid up at premium of Rs.4 per share for each preference share held in both the Companies.
3. Issue of 6 Equity shares of Rs.20 each in LK Ltd. @ Rs.18 paid up at a premium of Rs.4 per share for each equity share held in both the Companies. In addition necessary cash should be paid to the Equity Shareholders of both the Companies as is required to adjust the rights of shareholders of both the companies in accordance with the intrinsic value of the shares of both the companies.
4. Issue of such amount of fully paid 6% debentures in LK Ltd. as is sufficient to discharge the 5% debentures in K Ltd at a discount of 5% after takeover.

B)

1. The assets and liabilities are to be taken at book values Inventory and Trade receivables for which provisions at 2% and 2 ½ % respectively to be raised.
2. The trade receivables of K Ltd. included Rs.20,000 due from L Ltd.

C) The LK Ltd is to issue 15,000 new equity shares of Rs.20 each, Rs.18 paid up at premium of Rs.4 per shares so as to have sufficient working capital. Prepare ledger accounts in the books of K Ltd. and L Ltd. to close their books.

(SM)

PROBLEM 7:

The following are the summarized Balance Sheets of A Ltd. and B Ltd. as on 31.3.20X1:

Particulars	(Rs.in thousands)	
	A Ltd.	B Ltd.
LIABILITIES		
Share capital:		
Equity shares of 100 each fully paid up	2,000	1,000
Reserves	1,000	---
10% Debentures	500	---

Loans from Banks	250	450
Bank overdrafts	---	50
Trade payables	300	300
Total	4,050	1,800
ASSETS		
Tangible assets/fixed assets	2,700	850
Investments	700	---
Trade receivables	400	150
Cash at bank	250	---
Accumulated loss	---	800
Total	4,050	1,800

B Ltd. has acquired the business of A Ltd. The following scheme of merger was approved:

- i) Banks agreed to waive off the loan of Rs.60 thousand of B Ltd.
- ii) B Ltd. will reduce its shares to Rs. 10 per share and then consolidate 10 such shares into one share of Rs. 100 each (new share).
- iii) Shareholders of A Ltd. will be given one share (new) of B Ltd. in exchange of every share held in A Ltd.
- iv) Trade payables of B Ltd. includes Rs. 1,00,000 payable to A Ltd.

Pass necessary entries in the books of B Ltd. and prepare Balance Sheet after merger. **(SM)**

PROBLEM 8:

The financial position of two companies Hari Ltd. and Vayu Ltd. as on 31st march, 2015 was as under:

Name of the Companies : Hari Ltd and Vayu Ltd

Balance Sheet as at : 31st march 2012

		Particulars	Notes No.	Hari Ltd (Rs.)	Vayu Ltd (Rs.)
		1	2	3	4
1		EQUITY AND LIABILITIES:			
		Shareholder's funds			
	a	Share capital	1	11,00,000	4,00,000
	b	Reserves and Surplus	2	70,000	70,000
2		Current liabilities			
	a	Trade Payable (sundry creditors)		1,30,000	80,000

	b	Short term provisions (Retirement and gratuity fund)		50,000	20,000
		TOTAL		13,50,000	5,70,000
		ASSETS:			
		Non-current assets			
1	a	Fixed assets			
	I	Tangible assets	3	8,00,000	2,50,000
	II	Intangible assets (Good will)		50,000	25,000
		Current Assets			
	a	Inventories (Stock)		2,50,000	1,75,000
2	b	Trade receivables (Debtors)		2,00,000	1,00,000
	c	Cash and cash equivalents (Cash at bank)		50,000	20,000
		TOTAL		13,50,000	5,70,000

Notes to Accounts:

Particulars	Hari (Rs.)	Vayu (Rs.)
1. Shareholder's funds:		
Equity share capital (Rs.10 each)	10,00,000	3,00,000
9% preference share capital (Rs.100 each)	1,00,000	-
10% preference share capital (Rs.100 each)	-	1,00,000
2. Reserves and Surplus:		
General reserve	70,000	70,000
3. Tangible assets:		
Building	3,00,000	1,00,000
Machinery	5,00,000	1,50,000

Hari Ltd. absorbs Vayu Ltd. on the following terms:

- 10% Preference Shareholders are to be paid at 10% premium by issue of 9% Preference Shares of Hari Ltd.
- Goodwill of Vayu Ltd. is valued at Rs.50,000, Buildings are valued at Rs.1,50,000 and the Machinery at Rs.1,60,000.

3. Inventory to be taken over at 10% less value and Provision for Doubtful Debts to be created @ 7.5%.
4. Equity Shareholders of Vayu Ltd. will be issued Equity Shares @ 5% premium.

Prepare necessary Ledger Accounts to close the books of Vayu Ltd. and Show the acquisition entries in the books of Hari Ltd. Also draft the Balance Sheet after absorption as at 31st March, 2015.

(SM)

PROBLEM 9:

Consider the following summarized balance sheets of X Ltd. and Y Ltd.

Balance sheet as on 31st March, 20X1

Liabilities	X Ltd (Rs.000)	Y Ltd. (Rs.000)	Assets	X Ltd (Rs.000)	Y Ltd. (Rs.000)
Equity share capital (Rs. 10 each)	50,00	30,00	Land & Building	25,00	15,50
14% Preference share Capital (Rs.100 each)	22,00	17,00	Plant & Machinery	32,50	17,00
General reserve	5,00	2,50	Furniture & Fittings	5,75	3,50
Export profit reserve	3,00	2,00	Investment	7,00	5,00
Investment allowance Reserve		1,00	Inventory	12,50	9,50
Profit & Loss A/c	7,50	5,00	Trade receivables	9,00	10,30
13% Debentures (Rs.100 each)	5,00	3,50	Cash & Bank	7,25	5,20
Trade payables	4,50	3,50			
Other current liabilities	2,00	1,50			
	99,00	66,00		99,00	66,00

X Ltd. takes over Y Ltd. on 1st April, 20X1. X Ltd. discharges the purchase consideration as below:

- Issued 3,50,000 equity shares of Rs.10 each at par to the equity shareholders of Y Ltd.
- Issued 15% preference shares of Rs.100 each to discharge the preference shareholders of Y Ltd. at 10% premium.

The debentures of Y Ltd. will be converted into equivalent number of debentures of X Ltd. The statutory reserves of Y Ltd. are to be maintained for 2 more years.

Show the balance sheet of X Ltd. after amalgamation on the assumption that:

- a) The amalgamation is in the nature of merger.
- b) The amalgamation is in the nature of purchase.

(SM)

PROBLEM 10:

Super Express Ltd. and Fast Express Ltd. were in competing business. They decided to form a new company named Super-Fast Express Ltd. The summarized balance sheets of both the companies were as under:

Name of the Companies : Super Ltd and Fast Ltd

Balance Sheet as at : 31st march 2014

			Particulars	Notes No.	Super express Ltd. (Rs.)	Fast express Ltd. (Rs.)
			1	2	3	4
1			EQUITY AND LIABILITIES:			
			Shareholder's funds			
	A		Share capital	1	20,00,000	10,00,000
	B		Reserves and Surplus	2	1,00,000	2,60,000
2			Current liabilities			
	A		Trade Payable (sundry creditors)		60,000	40,000
	B		Short term provisions (Provident fund)		1,00,000	-
			TOTAL		22,60,000	13,00,000
1			ASSETS:			
			Non-current assets			
	A		Fixed assets			
		I	Tangible assets	3	14,00,000	11,00,000
		II	Intangible assets (Goodwill)		-	1,00,000
2			Current Assets			
	A		Inventories (Stock)		3,00,000	40,000
	B		Trade receivables (Debtors)		2,40,000	40,000

	C		Cash and cash equivalents	4	3,20,000	20,000
			TOTAL		22,60,000	13,00,000

Notes to Accounts:

Particulars	Super express	Fast express
1. Shareholder's funds		
20,000 equity shares of Rs.100 each	20,00,000	-
10,000 equity shares of Rs.100 each		10,00,000
2. Reserves and Surplus		
Insurance reserve	1,00,000	-
Employees profit sharing account	-	60,000
Reserve account	-	1,00,000
Surplus	-	1,00,000
3. Tangible assets		
Building	10,00,000	6,00,000
Machinery	4,00,000	5,00,000
4. Cash and cash equivalents		
Cash at bank	2,20,000	10,000
Cash in hand	1,00,000	10,000

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 Rs.100 each in lieu of purchase amounting to 30,000 shares, (20,000 for Super-Fast express Ltd. and 10,000 for fast express Ltd.). Decide type of Amalgamation and Prepare opening balance sheet of Super-Fast Express Ltd. **(SM)**

PROBLEM 11:

Galaxy Ltd. and Glory Ltd., are two companies engaged in the same business of chemicals. To mitigate competition, a new company Glorious Ltd, is to be formed to which the assets and liabilities of the existing companies, with certain exception, are to be transferred. The summarized Balance Sheet of Galaxy Ltd. and Glory Ltd. as at 31st March, 2020 are as follows.

				Galaxy Ltd.	Glory Ltd.
				Rs.	Rs.

(I)	Equity & Liabilities			
	(1) Shareholders' fund			
	<u>Share Capital</u>			
	Equity shares of Rs. 10 each		8,40,000	4,55,000
	<u>Reserves & Surplus</u>			
	General Reserve		4,48,000	40,000
	Profit & Loss A/c		1,12,000	72,000
	(2) Non-current Liabilities			
	Secured Loan-6% Debentures		-	3,30,000
	(3) Current Liabilities			
	Trade Payables		4,20,000	1,83,000
	Total		18,20,000	10,80,000
(II)	Assets			
	(1) Non-current assets			
	<u>Property, Plant & Equipment</u>			
	Freehold property, at cost		5,88,000	3,36,000
	Plant & Machinery, at cost less depreciation		1,40,000	84,000
	Motor vehicles, at cost less depreciation		56,000	-
	(2) Current Assets			
	Inventories		3,36,000	4,38,000
	Trade Receivables		4,62,000	1,18,000
	Cash at Bank		2,38,000	1,04,000
	Total		18,20,000	10,80,000

Assets and Liabilities are to be taken at book value, with the following exceptions:

1. The Debentures of Glory Ltd. are to be discharged, by the issue of 8% Debentures of Glorious Ltd. at a premium of 10%.
2. Plant and Machinery of Galaxy Ltd. are to be valued at Rs. 2,52,000.
3. Goodwill is to be valued at : Galaxy Ltd. Rs. 4,48,000 Glory Ltd. Rs. 1,68,000

4. Liquidator of Glory Ltd. is appointed for collection from trade debtors and payment to trade creditors. He retained the cash balance and collected Rs. 1,10,000 from debtors and paid Rs. 1,80,000 to trade creditors. Liquidator is entitled to receive 5% commission for collection and 2.5% for payments. The balance cash will be taken over by new company.

You are required to:

- A. Compute the number of shares to be issued to the shareholders of Galaxy Ltd. and Glory Ltd, assuming the nominal value of each share in Glorious Ltd. is Rs. 10.
- B. Prepare Balance Sheet of Glorious Ltd., as on 1st April, 2020 and also prepare notes to the accounts as per Schedule III of the Companies Act, 2013. **(QP-JAN 2021-Q.NO.2)**

PROBLEM 12:

The summarized Balance Sheets of Black Limited and White Limited as on 31st March, 2020 is as follows:

Particulars	Notes	Black Limited (Rs. In 000)	White Limited (Rs. In 000)
Equity and Liabilities			
Shareholders' Funds			
(a) Share Capital	1	6,000	3,600
(b) Reserves and Surplus	2	1,080	660
Current Liabilities			
Trade payables		600	360
Total		7,680	4,620
Assets			
Non-current assets			
Property, Plant and Equipment		3,600	2,400
Current assets			
(a) Inventories		960	720
(b) Trade receivables		1,680	1,080
(c) Cash and Cash Equivalents		1,440	420
Total		7,680	4,620

Note No.	Particulars	Black Limited (Rs. in 000)	White Limited (Rs. in 000)
1.	Share Capital Equity Shares of Rs. 100 each	6,000	3,600
	Reserves and Surplus		
2.	General Reserve	360	180
	Profit and Loss Account	720	480
	Total	1,080	660

1. Black Limited takes over White Limited on 1st July, 2020.
 2. No Balance Sheet of White Limited is available as on that date. It is, however estimated that White Limited earned profit of Rs. 2,40,000 after charging proportionate depreciation @ 10% p.a. on Property Plant and Equipment, during April-June, 2020.
 3. Estimated profit of Black Limited during these 3 months was Rs. 4,80,000 after charging proportionate depreciation @ 10% p.a. on Property Plant and Equipment
 4. Both the companies have declared and paid 10% dividend within this 3 months' period.
 5. Goodwill of White Limited is valued at Rs. 2,40,000 and Property Plant and Equipment are valued at Rs. 1,20,000 above the depreciated book value on the date of takeover.
 6. Purchase consideration is to be satisfied by Black Limited by issuing shares at par.
- Ignore income tax. You are required to:
- (i) Compute No. of shares to be issued by Black Limited to White Limited against purchase consideration.
 - (ii) Calculate the balance of Net Current Assets of Black Limited and White Limited as on 1st July, 2020.
 - (iii) Give balance of Profit or Loss of Black Limited as on 1st July, 2020
 - (iv) Give balance of Property Plant and Equipment as on 1st July, 2020 after takeover.

(QP-JULY 2021-5(a))

PROBLEM 13:

High Ltd. and Low Ltd. were amalgamated on and from, 1st April, 2020. A new company Little Ltd. was formed to take over the business of the existing Companies. The summarized Balance sheets of High Ltd. and Low Ltd. as on 31st March, 2020 are as under:

(Rs. in Lakhs)

Liabilities	High Ltd.	Low Ltd.	Assets	High Ltd.	Low Ltd.
Share Capital:			Property, Plant and Equipment:		
Equity Shares of Rs. 100 each	1000	850	Land & Building	670	385
14% Pref Shares of Rs. 100 each	320	175	Plant & Machinery	475	355
Reserves & Surplus:			Investments	95	80
Revaluation Reserve	225	110	Current Assets:		
General Reserve	360	240	Stock	415	389
Investment Allowance Reserve	80	40	Sundry Debtors	322	213
P & L Account	85	82	Bills Receivables	35	-
Non-Current Liabilities:			Cash & Bank	303	166
Secured Loans:					
13% Debentures (Rs. 100 each)	100	56			
Unsecured Loans (Public Deposits)	50	-			
Current Liabilities & Provisions:		-			
Sundry Creditors	65	35			
Bills Payable	30	-			
TOTAL	2315	1588	TOTAL	2315	1588

Other Information:

- (1) 13% Debenture holders of High Ltd. & Low Ltd. are discharged by Little Ltd. by issuing such number of its 15% Debentures of Rs. 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 Little Ltd. at a price of Rs. 125 per share (Face Value Rs. 100)
- (3) Little Ltd. will issue 4 Equity Shares for each Equity Share of High Ltd. & 3 equity shares for each Equity Share of Low Ltd. The shares are to be issued at Rs. 35 each having a face value of Rs. 10 per share.

(4) Investment Allowance Reserve is to be maintained for two more years.

Prepare the Balance sheet of Little Ltd. as on 1st April, 2020 after the amalgamation has been carried out in basis of in the nature of Purchase.

(QP-Nov 2020 -3(a))

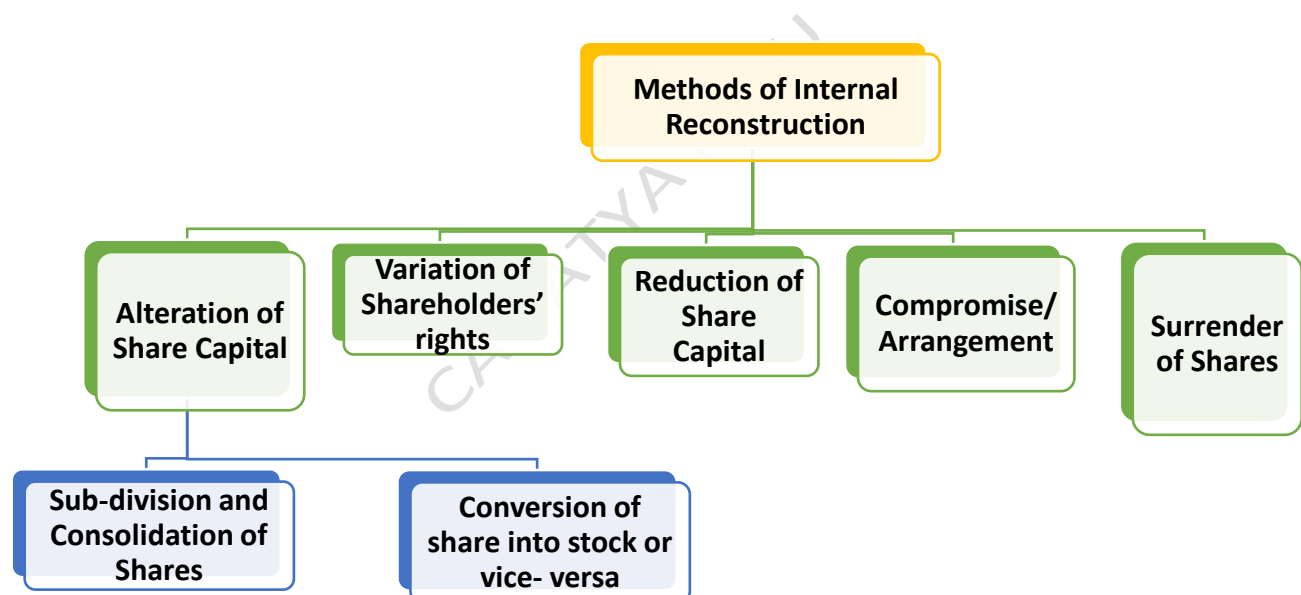
CA SATYA RAJU

4.ACCOUNTING FOR RECONSTRUCTION OF COMPANIES

INTERNAL RECONSTRUCTION:

It is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered, by reducing the paid-up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganize capital or to compound with creditors so that company can be bailed out from present situation without winding up the existing company.

METHODS OF INTERNAL RECONSTRUCTION:



1. Alteration of Share Capital:

According to the Section 61 of the Companies Act 2013, a limited company can alter its share capital, if so authorized by its Articles, by passing an ordinary resolution in the general meeting.

The following types of Alteration can be done under Section 61

- a. Increase of authorized share capital;
- b. Consolidation and sub-division into shares of larger or smaller denominations;
- c. Conversion of all or any of the shares into stock or vice versa;
- d. Cancellation of shares which have not been taken or agreed to be taken by any person.

2. Variation of Shareholders Rights

Section 48 of the Companies Act, 2013 provides that when a company has issued different classes of shares with different rights or privileges attached to such shares e.g. rights as to dividend, voting rights etc., any of such right may be changed in any manner.

Example: The company may change rate of (a) dividend on preference shares or (b) convert cumulative preference shares into non-cumulative preference shares without changing the amount of share capital by passing the following journal entries:

- a. Debit (Old)% Cum. Pref. Share Capital Account
Credit (New)% Cum. Pref. Share Capital Account
- b. Debit ...% Cum. Pref. Share Capital Account
Credit ...% Non-cum. Pref. Share Capital Account

3. Reduction of Share Capital:

Section 66 of the Companies Act, 2013 lays down the procedure in respect of reduction of share capital. Subject to confirmation by the Tribunal on an application by the company, a company may, by a special resolution, reduce the share capital in the following manner-

(a) Extinguishing or reducing the liability of the shareholders in respect of unpaid amount on the shares held by them;

Here the shareholders are not called upon to pay the unpaid amount on shares held by them in future.

Example:

A company decides to reduce Rs. 10 per share, into Rs. 7.5 per share fully paid up, by cancelling the unpaid amount of Rs. 2.5 per share. The entry in this case would be

Share Capital (Partly Paid-Up) Account	Dr.	(Rs. 7.5 (Fv Rs.10) X No. of Shares)
To Share Capital (Fully Paid-up) Account		(Rs. 7.5 (Fv- Rs.7.5) X No. of Shares)

(b) Paying off any paid-up share capital which is in excess of its requirements:

When its not possible for the company to employ profitably its paid-up capital, then in such case it may decide to refund the excess capital to its shareholders.

Example:

A company having fully paid-up share of Rs. 10 each, decides to pay-off Rs. 2 per share to make it of Rs. 8 fully paid-up, entries in that case would be

- i. Share Capital Account (Rs. 10) Dr. (Rs. 10 X No. of Shares)
 To Share Capital Account (Rs. 8) (Rs. 8 X No. of Shares)
 To Sundry Shareholders Account (Rs. 2 X No. of Shares)
- ii. Sundry Shareholders Account Dr. (Rs. 2 X No. of Shares)
 To Bank Account (Rs. 2 X No. of Shares)

(c) Cancelling any paid-up share capital which is lost or is unrepresented by available assets:

i. Reduction in paid up value only-

Here the nominal value of the share remains the same and only the paid value is reduced.

Example: The shareholders may agree to reduce the paid capital of Rs. 100 per share to paid value of Rs. 10 per share. The sacrifice is Rs. 90 and the entry will be

- Share Capital Account Dr. (Rs. 90 X No. of Shares)
 To Capital Reduction Account (Rs. 90 X No. of Shares)

ii. Reduction in both nominal and paid-up values-

In this case, both the paid up capital and nominal value of the shares are reduced. Continuing the above example, the entry will be:

- Share Capital Account (Rs. 100 Share) Dr. (Rs. 100 X No. of Shares)
 To Share Capital (Rs. 10 Share) (Rs. 10 X No. of Shares)
 To Capital Reduction Account (Rs. 90 X No. of Shares)

Thus in such treatment we debit the original Share Capital Account so as to close it, credit new Share Capital Account with the amount treated as paid up; and credit Capital Reduction Account with the difference.

4. Compromise/Arrangements:

A scheme of compromise and arrangement is an agreement between a company and its members and outside liabilities when the company faces financial problems. Such an arrangement therefore also involves sacrifices by shareholders, or creditors or debenture holders or by all of them.

5. Surrender of Shares:

In this method, shares are divided into shares of smaller denominations and then the shareholders are made to surrender their shares to the company. These shares are then allotted to debenture holders and creditors so that their liabilities are reduced. The unutilized surrendered shares are then cancelled by transferring them to Reconstruction Account.

IMPORTANT POINTS:

1. Under the above-mentioned methods- the alteration of share capital and the varying of the shareholders rights do not involve opening the capital reduction/reconstruction account.
2. It is only under the reduction of share capital, unrepresented reserves, compromise/ arrangements with the outside liabilities and surrender of shares, there shall be capital reduction/reconstruction account used to which the unrepresented assets/liabilities will be transferred as per the arrangement.
3. An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to Capital Reduction Account (or Reconstruction Account).
4. Eliminate debit balance of profit and loss account and all over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account, it should be transferred to the Capital Reserve Account.
5. If there is any balance in the reconstruction account it is finally transferred to the Capital reserve under Reserves and Surplus. But if the amount for writing off the assets and accumulated losses is more than the reconstruction amount, then reserves will be adjusted against the same.
6. While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:
 - a. After the name of the company, the words “**and Reduced**” should be added only if the Court so orders.
 - b. In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

On 31-12-20X1, B Ltd. had 20,000 Rs. 10 Equity Shares as authorised capital and the shares were all issued on which Rs. 8 was paid up. In June, 20X2 the company in general meeting decided to sub – divide each share into two shares of Rs. 5 with Rs. 4 paid up. In June, 20X3 the company in general meeting resolved to consolidate 20 shares of Rs. 5, Rs. 4 per share paid up into one share of Rs. 100 each, Rs. 80 paid up.

Pass entries and show how share capital will appear in notes to Balance Sheet as on 31-12-20X1, 31-12-20X2, 31-12-20X3. (SM)

PROBLEM 2:

C Ltd. had Rs. 5,00,000 authorised capital on 31-12-20X1 dividend into shares of Rs. 100 each out of which 4,000 shares were issued and fully paid up. In June 20X2 the company decided to convert the issued shares into stock. But in June, 20X3 the Company re – converted the stock into shares of Rs. 10 each, fully paid up.

Pass entries and show how share capital will appear in Notes to Balance Sheet as on 31-12-20X1, 31-12-20X2, 31-12-20X3. (SM)

PROBLEM 3:

The Balance Sheet of A & Co. Ltd. as on 31-12-20X1 is as follows:

Assets	Rs.	Rs.
Fixed Assets:		
Freehold property	4,25,000	
Plant	50,000	
Patent	37,500	
Goodwill	1,30,000	6,42,500
Traded Investments (at cost)		55,000
Current Assets:		
Trade receivables	4,85,000	

Inventory	4,25,000	9,10,000
Profit and Loss Account		5,35,000
Total		21,42,500
Liabilities		
Share Capital:		
4,000 6% Cumulative Preference Shares of Rs. 100 each	4,00,000	
75,000 Equity Shares of Rs. 10 each	7,50,000	11,50,000
6% Debentures (Secured on Freehold Property)	3,75,000	
Accrued Interest	22,500	3,97,500
Current Liabilities:		
Bank Overdraft	1,95,000	
Trade payables	3,00,000	
Directors' Loans	1,00,000	5,95,000
		21,42,500

The Court approved a Scheme of re-organisation to take effect on 1-1-20X2, whereby:

- i) The Preference shares to be written down to Rs. 75 each and Equity Shares to Rs. 2 each.
- ii) Of the Preference Share dividends which are in arrears for four years, three fourths to be waived and Equity Shares of Rs.2 each to be allotted for the remaining quarter.
- iii) Accrued interest on debentures to be paid in cash.
- iv) Debenture-holders agreed to take over freehold property, book value Rs.1,00,000 at a valuation of Rs.1,20,000 in part repayment of their holdings and to provide additional cash of Rs. 1,30,000 secured by a floating charge on company's assets at an interest rate of 8% p.a.
- v) Patents and Goodwill to be written off.
- vi) Inventory to be written off by Rs. 65,000.
- vii) Amount of Rs. 68,500 to be provided for bad debts.
- viii) Remaining freehold property to be re-valued at Rs. 3,87,500
- ix) Trade Investments be sold for Rs. 1,40,000.
- x) Directors to accept settlement of their loans as to 90% thereof by allotment of equity shares of Rs. 2 each and as to 5% in cash, and balance 5% being waived.

- xi) There were capital commitments totalling Rs. 2,50,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.
- xii) Ignore taxation and cost of the scheme.

You are requested to show Journal entries reflecting the above transactions (including cash transactions) and prepare the Balance Sheet of the company after completion of the Scheme. **(SM)**

PROBLEM 4:

Given below is the summarized balance sheet of Rebuilt Ltd. as on 31.3.20X1:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Authorised and issued capital: 12,000, 7% Preference shares of Rs.50 each (Note: Preference dividend is in arrear for five years)	6,00,000	Building at cost less depreciation	4,00,000
15,000 Equity shares of Rs. 50 each	7,50,000	Plant at cost less depreciation	2,68,000
	13,50,000	Trademarks and goodwill at cost	3,18,000
Loan	5,73,000	Inventory	4,00,000
Trade payables	2,07,000	Trade receivables	3,28,000
Other liabilities	35,000	Profit and loss A/c	4,51,000
	21,65,000		21,65,000

The Company is now earning profits short of working capital and a scheme of reconstruction has been approved by both the classes of shareholders. A summary of the scheme is as follows:

- The equity shareholders have agreed that their Rs.50 shares should be reduced to Rs. 2.50 by cancellation of Rs. 47.50 per share. They have also agreed to subscribe for three new equity shares of Rs. 2.50 each for each equity share held.
- The preference shareholders have agreed to cancel the arrears of dividends and to accept for each Rs. 50 share, 4 new 5% preference shares of Rs. 10 each, plus 6 new equity shares of Rs. 2.50 each, all credited as fully paid.
- Lenders to the company for Rs.1,50,000 have agreed to convert their loan into share and for this purpose they will be allotted 12,000 new preference shares of Rs. 10 each and 12,000 new equity shares of Rs. 2.50 each.

- d) The directors have agreed to subscribe in cash for 40,000, new equity shares of Rs. 2.50 each in addition to any shares to be subscribed by them under (a) above.
- e) Of the cash received by the issue of new shares, Rs. 2,00,000 is to be used to reduce the loan due by the company.
- f) The equity share capital cancelled is to be applied:
- To write off the debit balance in the profit and loss A/c; and
 - To write off Rs. 35,000 from the value of plant.

Any balance remaining is to be used to write down the value of trademarks and goodwill.

Show by journal entries how the financial books are affected by the scheme and prepare the balance sheet of the company after reconstruction. The nominal capital as reduced is to be increased to Rs.6,50,000 for preference share capital and Rs.7,50,000 for equity share capital. (SM)

PROBLEM 5:

Repair Ltd. is in the hands of a receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 30th June, 2015:

Liabilities	Amount	Assets	Amount
6,000 shares of Rs.60 each, Rs.30 paid up		Property, machinery and plant etc. (Cost Rs. 3,90,000) Estimated at	1,50,000
First debentures	3,00,000	Cash in hand of the receiver	<u>2,70,000</u>
Second debentures	6,00,000	Charged under debentures	4,20,000
Unsecured trade payables	4,50,000	Uncalled capital	<u>1,80,000</u>
			6,00,000
		Deficiency	7,50,000
	13,50,000		13,50,000

A holds the first debentures for Rs.3,00,000 and second debentures for Rs. 3,00,000. He is also an unsecured creditor for Rs.90,000. B holds second debentures for Rs. 3,00,000 and is an unsecured trade payables for Rs. 60,000.

The following scheme of reconstruction is proposed:

1. A is to cancel Rs.2,10,000 of the total debt owing to him, to bring Rs. 30,000 in cash and to take first debentures (in cancellation of those already issued to him) for Rs.5,10,000 in satisfaction of all his claims.
2. B is to accept Rs.90,000 in cash in satisfaction of all claims by him.
3. In full settlement of 75% of the claim, unsecured creditors (other than A and B) agreed to accept four shares of Rs.7.50 each, fully paid against their claim for each share of Rs.60. The balance of 25% is to be postponed and to be payable at the end of three years from the date of Court's approval of the scheme. The nominal share capital is to be increased accordingly.
4. Uncalled capital is to be called up in full and Rs.52.50 per share cancelled, thus making the shares of Rs. 7.50 each.

Assuming that the scheme is duly approved by all parties interested and by the Court, give necessary journal entries.

SM

PROBLEM 6:

The Balance Sheet of Vaibhav Ltd. as on 31st March 2014 is as follows:

Liabilities	Rs.	Assets	Rs.
Equity Shares of Rs. 100 each	2,00,00,000	PPE	2,50,00,000
6%, Cumulative Preference Shares of Rs. 100 each	1,00,00,000	Investments (Market Value Rs. 19,00,000)	20,00,000
5% Debentures of Rs. 100 each	80,00,000	Current Assets	2,00,00,000
Sundry Creditors	1,00,00,000	P & L A/c	12,00,000
Provision for taxation	2,00,000		
	4,82,00,000		4,82,00,000

The following scheme of Internal Reconstruction is sanctioned:

1. All the existing equity shares are reduced to Rs. 40 each.
2. All preference shares are reduced to Rs. 60 each.
3. The rate of Interest on Debentures increased to 6%. The Debenture holders surrender their existing debentures of Rs. 100 each and exchange the same for fresh debentures of Rs. 70 each for every debenture held by them.
4. PPE are to be written down by 20%.
5. Current assets are to be revalued at Rs. 90,00,000.

6. Investments are to be brought to their market value.
7. One of the creditors of the company to whom the company owes Rs. 40,00,000 decides to forgo 40% of his claim. The creditor is allotted with 60000 equity shares of Rs. 40 each in full and final settlement of his claim.
8. The taxation liability is to be settled at Rs. 3,00,000.
9. It is decided to write off the debit balance of Profit & Loss A/c.

Pass journal entries and show the Balance Sheet of the company after giving effect to the above. **SM**

PROBLEM 7:

Following is the Draft Balance Sheet of ABC Ltd. Co.as at 31st March, 2015:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share capital:		Plant and Machinery	9,00,000
2,00,000 Equity shares of Rs.10 each fully paid up	20,00,000	Furniture and fixtures	2,50,000
6,000 8% Preference Shares of Rs.100 each	6,00,000	Patents and copy rights	70,000
9 % Debentures	12,00,000	Investments (at cost) (Market value Rs. 55,000)	68,000
Bank overdraft	1,50,000	Inventory	14,00,000
Trade Payable	5,92,000	Trade receivables	14,39,000
		Cash and bank balance	10,000
		Profit & Loss A/c	4,05,000
	45,42,000		45,42,000

The following scheme of reconstruction was finalized:

1. Preference shareholders would give up 30% of their capital in exchange for allotment of 11% Debentures to them.
2. Debenture holders having charge on plant and machinery would accept plant and machinery in full settlement of their dues.

3. Inventory equal to Rs. 5,00,000 in book value will be taken over by trade payables in full settlement of their dues.
4. Investment value to be reduced to market price.
5. The company would issue 11% Debentures for Rs.3,00,000 to augment its working capital requirement after settlement of bank overdraft.

Give necessary journal entries reflecting the above scheme of reconstruction in the books of the ABC Ltd. Co. Prepare capital reduction account and balance sheet of the company after internal reconstruction

SM

PROBLEM 8:

The Summarised Balance Sheet of Revise Limited as at 31st March, 20X1 was as follows:

Liabilities	Rs.	Assets	Rs.
Authorised and subscribed capital:		Fixed Assets :	
10,000 Equity shares of Rs.100 each fully paid	10,00,000	Machineries	1,00,000
		Current assets :	
Unsecured Loans :		Inventory	3,20,000
12% Debentures	2,00,000	Trade receivables	2,70,000
Accrued interest	24,000	Bank	30,000
Current liabilities		Profit and loss account	6,00,000
Trade payables -	72,000		
Provision for income tax	24,000		
	13,20,000		13,20,000

It was decided to reconstruct the company for which necessary resolution was passed and sanctions were obtained from appropriate authorities. Accordingly, it was decided that:

1. Each share is sub-divided into ten fully paid up equity shares of Rs 10 each.
2. After sub-division, each shareholder shall surrender to the company 50% of his holding, for the purpose of re-issue to debenture holders and trade payables as necessary.
3. Out of shares surrendered, 10,000 shares of Rs 10 each shall be converted into 12% preference shares of Rs 10 each, fully paid up.

4. The claims of the debenture-holders shall be reduced by 75 per cent. In consideration of the reduction, the debenture holders shall receive preference shares of Rs 1,00,000 which are converted out of shares surrendered.
5. Trade payables claim shall be reduced to 50 per cent, it is to be settled by the issue of equity shares of Rs 10 each out of shares surrendered.
6. Balance of profit and loss account to be written off.
7. The shares surrendered and not re-issued shall be cancelled.

You are required to show the journal entries giving effect to the above and the resultant Balance Sheet.

SM

PROBLEM 9:

Parth Ltd, had laid down the following terms upon the sanction of the reconstruction plan by the court

1. Furniture and Fixtures which stood at the books at Rs. 1,50,000 to be written down to Rs. 95,000. The freehold premises which was valued at Rs. 7,00,000 showed an appreciation of Rs. 55,000.
2. Plant and machinery showed fall in value of Rs. 89,000, to be recorded in the books. Investment at Rs. 2,00,000 was brought down to the existing market value at Rs. 1,05,000.
3. Debenture holders accepted to receive the following in lieu of their present 9% debentures of Rs. 2,50,000
 - i. 1/5th of the total to be paid in cash to them.
 - ii. To take over the land and buildings of value Rs. 72,000.
 - iii. To forgo the remaining unpaid portion as a policy of reconstruction.

Write off the profit and loss A/c debit balance at Rs. 70,000 which had been accumulated over the years. In case of any shortfall, the balance of the General reserve of Rs. 1,50,000 can be utilized to write off the losses under reconstruction scheme.

Show the necessary journal entries as part of the reconstruction process considering that balance in general reserve utilized to write off the losses as per reconstruction scheme.

(PRACTICAL QUESTION-1- SM)

PROBLEM 10

The following is the Balance Sheet of Star Ltd. as on 31st March, 2019:

			Rs.
A.	Equity & Liabilities		
	1.	Shareholders' Fund:	

	(a)	Share Capital:	
		9,000 7% Preference Shares of Rs. 100 each fully paid	9,00,000
		10,000 Equity Shares of Rs. 100 each fully paid	10,00,000
	(b)	Reserve & Surplus:	
		Profit & Loss Account	(2,00,000)
2.		Non-current liabilities:	
		"A" 6% Debentures (Secured on Bombay Works)	3,00,000
		"B" 6% Debentures (Secured on Chennai Works)	3,50,000
3.		Current Liabilities and Provisions:	
	(a)	Workmen's Compensation Fund:	
		Bombay Works	10,000
		Chennai Works	5,000
	(b)	Trade Payables	1,25,000
		Total	24,90,000
B.		Assets:	
		Non- current Assets:	
1.		PPE:	
		Bombay Works	9,50,000
		Chennai Works	7,75,000
2.		Investment:	
		Investments for Workman's Compensation Fund	15,000
3.		Current Assets:	
	(a)	Inventories	4,50,000
	(b)	Trade Receivables	2,50,000
	(c)	Cash at Bank	50,000
			24,90,000

A reconstruction scheme was prepared and duly approved. The salient features of the scheme were as follows:

1. Paid up value of 7% Preference Share to be reduced to Rs. 80, but the rate of dividend being raised to 9%.
2. Paid up value of Equity Shares to be reduced to Rs. 10.

3. The directors to refund Rs. 50,000 of the fees previously received by them.
4. Debenture holders forego their interest of Rs. 26,000 which is included among the trade payables.
5. The preference shareholders agreed to waive their claims for preference share dividend, which is in arrears for the last three years.
6. "B" 6% Debenture holders agreed to take over the Chennai Works at Rs. 4,25,000 and to accept an allotment of 1,500 equity shares of Rs. 10 each at par, and upon their forming a company called Zia Ltd. (to take over the Chennai Works) they allotted 9,000 equity shares of Rs. 10 each fully paid at par to Star Ltd.
7. The Chennai Workmen's compensation fund disclosed that there were actual liabilities of Rs. 1,000 only. As a consequence, the investments of the fund were realized to the extent of the balance. Entire investments were sold at a profit of 10% on book value and the proceeds were utilized for part payment of the creditors.
8. Inventory was to be written off by Rs. 1,90,000 and a provision for doubtful debts is to be made to the extent of Rs. 20,000.
9. Chennai works completely written off.
10. Any balance of the Capital Reduction Account is to be applied as two-third to write off the value of Bombay Works and one-third to Capital Reserve.

Pass necessary Journal Entries in the books of Star Ltd. after the scheme has been carried into effect.

(MAY 2020-RTP- PROBLEM NO.9)

5.ACCOUNTING FOR LIQUIDATION OF COMPANIES

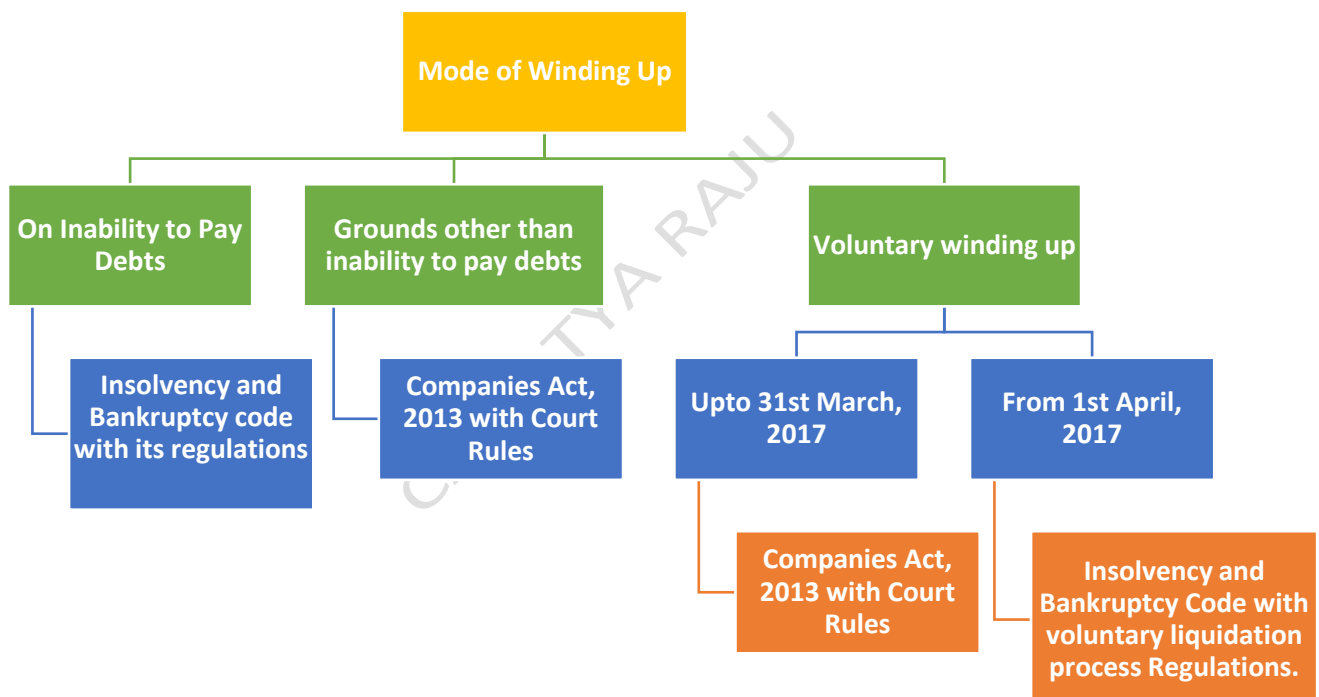
MEANING OF LIQUIDATION:

Liquidation is the legal procedure by which the company comes to an end.

DEFINITION OF WINDING UP:

As per Section 2 (94A) of the Companies Act, 2013, winding up means winding up under this Act or liquidation under the Insolvency and Bankruptcy Code, 2016, as applicable.

MODE OF WINDING UP:

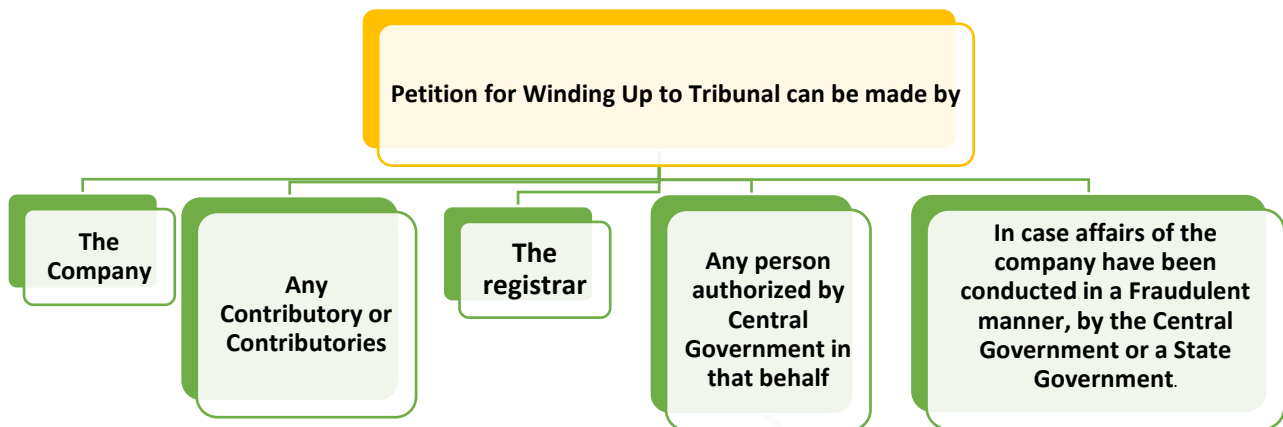


Circumstances in Which Company May be Wound Up by Tribunal:

1. The company has resolved that the company be wound up by the Tribunal. The company has require to pass special resolution.
2. The company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality
3. The Registrar or any other person authorised by the Central Government by notification under this Act can make an application to tribunal. The Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up.

4. The company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding 5 consecutive financial years.
5. The Tribunal is of the opinion that it is just and equitable that the company should be wound up.

PETITION FOR WINDING UP:



VOLUNTARY WINDING UP:

Provisions under Companies Act, 2013 relating to voluntary winding up stand omitted due to section 255 of Insolvency & Bankruptcy Code, 2016

Provisions of the Insolvency and Bankruptcy Code, 2016:

1. A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate voluntary liquidation proceedings under the provisions of the Chapter V- Voluntary liquidation of corporate persons of the Insolvency and Bankruptcy Code, 2016.
2. The voluntary liquidation of a corporate person shall meet such conditions and procedural requirements as may be specified by the Board.
3. Voluntary liquidation proceedings of a corporate person registered as a company shall meet the following conditions, namely:
 - a. A declaration from majority of the directors of the company verified by an affidavit stating that—
 - i. They have made a full inquiry into the affairs of the company and they have formed an opinion that either the company has no debt or that it will be able to pay its debts in full from the proceeds of assets to be sold in the voluntary liquidation; and
 - ii. The company is not being liquidated to defraud any person;
 - b. The declaration under sub-clause (a) shall be accompanied with the following documents, namely:

- i. Audited financial statements and record of business operations of the company for the previous two years or for the period since its incorporation, whichever is later;
 - ii. A report of the valuation of the assets of the company, if any prepared by a registered valuer;
- c. Within four weeks of a declaration under sub-clause (a), there shall be—
 - i. A special resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily and appointing an insolvency professional to act as the liquidator; or
 - ii. A resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily as a result of expiry of the period of its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company shall be dissolved, as the case may be and appointing an insolvency professional to act as the liquidator: Provided that the company owes any debt to any person, creditors representing two-thirds in value of the debt of the company shall approve the resolution passed under sub-clause (c) within seven days of such resolution.
- 4. The company shall notify the Registrar of Companies and the Board about the resolution under sub-section (3) to liquidate the company within seven days of such resolution or the subsequent approval by the creditors, as the case may be.
- 5. Subject to approval of the creditors under sub-section (3), the voluntary liquidation proceedings in respect of a company shall be deemed to have commenced from the date of passing of the resolution under sub-clause (c) of sub-section (3).
- 6. The provisions of sections 35 to 53 of Chapter III (Liquidation process) and Chapter VII (Offences and penalties) shall apply to voluntary liquidation proceedings for corporate persons with such modifications as may be necessary.
- 7. Where the affairs of the corporate person have been completely wound up, and its assets completely liquidated, the liquidator shall make an application to the Adjudicating Authority for the dissolution of such corporate person.
- 8. The Adjudicating Authority shall on an application filed by the liquidator under sub-section (7), pass an order that the corporate debtor shall be dissolved from the date of that order and the corporate debtor shall be dissolved accordingly.

9. A copy of an order under sub-section (8) shall within fourteen days from the date of such order, be forwarded to the authority with which the corporate person is registered.

STATEMENT OF AFFAIRS:

In case of winding up by Tribunal, Section 272(5) of the Companies Act, 2013 provides that a petition presented by the company for winding up before the Tribunal shall be admitted only if accompanied by a statement of affairs in such form and in such manner as may be prescribed.

The broad lines on which the Statement of Affairs is prepared are the following

1. Include assets on which there is no fixed charge at the value they are expected to realise. Students should note to include calls in arrear but not uncalled capital.
2. Include assets on which there is a fixed charge. The amount expected to be realised would be compared with the amount due to the creditor concerned. Any surplus is to be extended to the other column. A deficit (the amount owed to the creditor exceeding the amount realisable from the asset) is to be added to unsecured creditors.
3. The total of assets in point (1) and any surplus from assets mentioned in point (2) is available for all the creditors (except secured creditors already covered by specifically mortgaged assets).
4. From the total assets available, the following should be deducted one by one:- (i) Preferential creditors, (ii) Debentures having a floating charge, and (iii) Unsecured creditors. If a minus balance emerges, there would be deficiency as regards creditors, otherwise there would be a surplus.
5. The amount of total paid-up capital (giving details of each class of shares) should be added and the figure emerging will be deficiency (or surplus) as regards members.

Statement of affairs should accompany eight lists:

List A Full particulars of every description of property not specifically pledged and included in any other list are to be set forth in this list.

List B Assets specifically pledged and creditors fully or partly secured.

List C Preferential creditors for rates, taxes, salaries, wages and otherwise.

List D List of debenture holders secured by a floating charge.

List E Unsecured creditors.

List F List of preference shareholders.

List G List of equity shareholders.

List H Deficiency or surplus account.

DEFICIENCY ACCOUNT:

1. The official liquidator will specify a date for period (minimum three years) beginning with the date on which information is supplied for preparation of an account to explain the deficiency or surplus. On that date, either assets would exceed capital plus liabilities, that is, there would be a reserve or there would be a deficit or debit balance in the Profit and Loss Account.
2. The Deficiency account is divided into two parts:
 - a. The first part starts with the deficit (on the given date) and contains every item that increases deficiency or reduces surplus such as losses, dividends etc.
 - b. The second part starts with the surplus on the given date and includes all profits. If the total of the first exceeds that of the second, there would be a deficiency to the extent of the difference, and if the total of the second part exceeds that of the first, there would be a surplus.

<u>PARTICULARS</u>	<u>AMOUNT(RS)</u>
Opening Debit balance in P &I	XXXX
<u>ITEMS CONTRIBUTING TO DEFICIT OR REDUCES SURPLUS</u>	
a) Operating Losses	XXXX
b) Abnormal and any other losses	XXXX
c) Dividend and Bonus shares declared during the period	XXXX
d) Realization loss due to Assets & Liabilities realized as form part of Liquidation	XXXX
Opening Reserve	XXXX
<u>ITEMS CONTRIBUTING TO DEFICIT OR REDUCES SURPLUS</u>	
a) Operating Profits	XXXX
b) Abnormal and any other profits	XXXX
c) Realization profits due to Assets & Liabilities realized as form part of Liquidation	XXXX
NET SURPLUS/DEFISIT AS PER LIST H	XXXX

LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT:

In case of voluntary winding up, the statement prepared by the Liquidator showing receipts and payment of cash is called "Liquidator's Statement of Account". In case of compulsory winding up, the statement is known as "Official Liquidator's Final Account".

While Preparing the Statement of Account, the following points should be noted:

1. Assets are included in the prescribed order of liquidity.
2. In case of assets specifically charged in favour of creditors, only the surplus from it, if any, is recognised as “Surplus from Securities”.
3. Net result of trading entered on the receipts side, profits being added and losses being deducted.
4. Payments made to redeem securities and cost of execution, i.e. cost of collecting debts, are deducted from the total receipts.
5. Payments are made as shown in the following order:
 - a. Legal Charges;
 - b. Liquidator’s Remuneration;
 - c. Liquidation Expenses;
 - d. Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);
 - e. Preferential creditors (in actual practice, preferential creditors are paid before debenture holders having a floating charge).
 - f. Unsecured creditors, shareholders for dividends declared but not yet paid;
 - g. Preference shareholders; and
 - h. Equity shareholders.
6. Arrears of dividends on cumulative preference shares should be paid up to the date of winding up.
7. In case of partly paid shares, it should be seen whether any amount is to be called up on such shares.
 Firstly, the equity shareholders should be called up to pay the necessary amount (not exceeding the amount of uncalled capital). If creditors’ claims cannot be satisfied with that amount, Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying off creditors.
8. The loss suffered by each class of shareholders, i.e. the amount that cannot be repaid, should be proportionate to the nominal value of the share. The loss per shares have nominal value of Rs. 100, and one set of shareholders has paid Rs. 80 per share and other set has paid Rs. 60 per share. Suitable adjustment will have to be made in cash in such a case; the latter set must contribute Rs. 20 first or the first set must be paid Rs. 20 first.

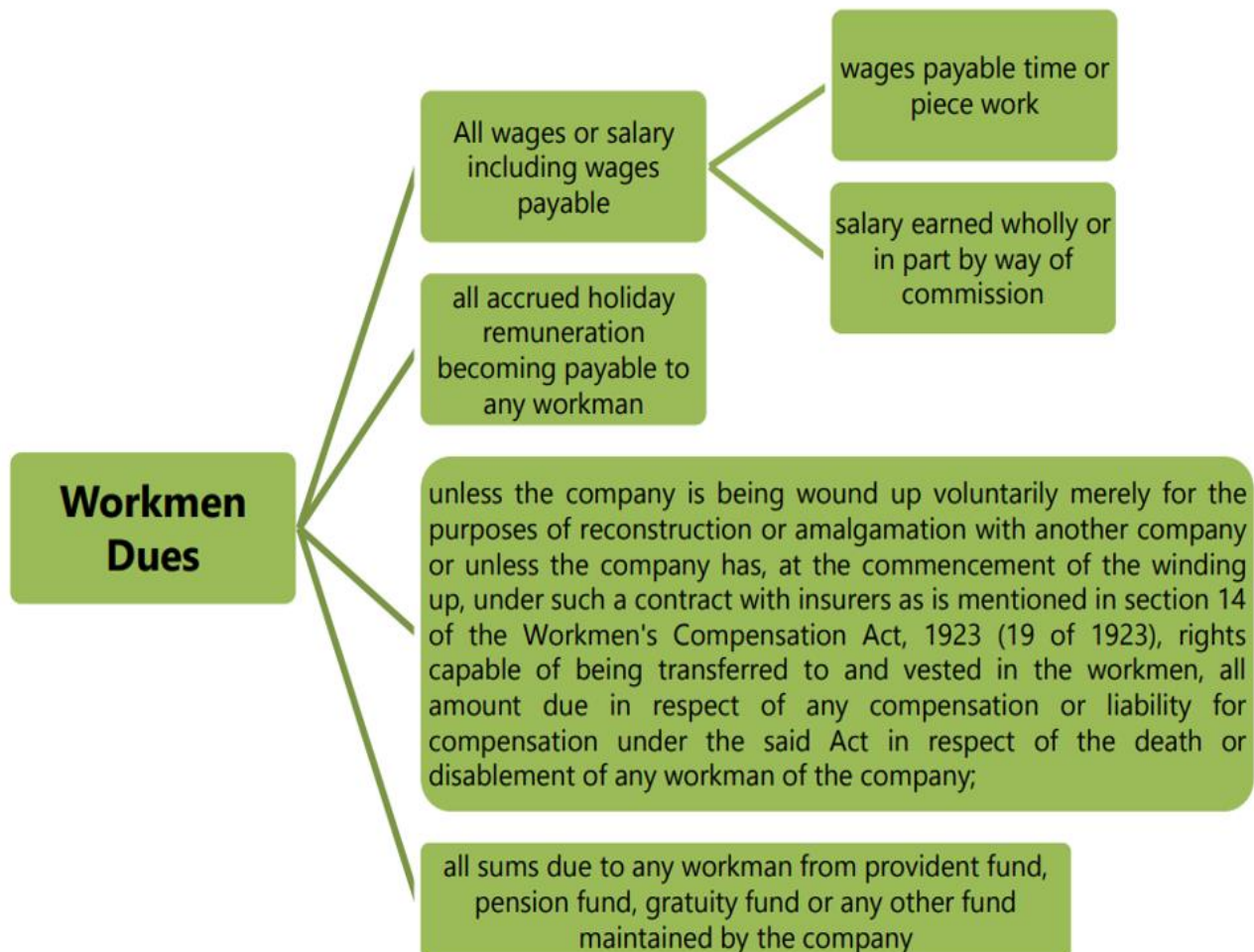
OVERRIDING PREFERENTIAL PAYMENTS (SECTION 326):

In the winding up of a company, the following debts should be paid in priority to all other debts, as per section 326:

1. Workmen's dues; and
2. Where a secured creditor has realized a secured asset, so much of the debts due to such secured creditor as could not be realized by him or the amount of the workmen's portion in his security (if payable under the law), whichever is less, pari-passu with the workmen's dues.

Explanation: For the purposes of this section

1. Workmen, in relation to a company, means the employees of the company, being workmen within the meaning of Section 2 (s) of the Industrial Disputes Act, 1947;
2. Workmen dues, in relation to a company, means the aggregate of the following sums due from the company to its workmen, namely:



(c) The following payment should be made in priority to secured creditors.

All wages or salary including wages payable

all accrued holiday remuneration becoming payable to any workman

If the above payments are payable for a period of 2 years preceding the winding up order then the same shall be paid in priority to all other debts (including debts due to secured creditors), within a period of 30 days of sale of assets and shall be subject to such charge over the security of secured creditors.

PREFERENTIAL CREDITORS (SECTION 327):

In a winding up there should be paid in priority to all other debts subject to the provisions of section 326.



1. **Government Taxes**: All revenues, taxes, cess and rates due from the company to the Central Government or a State Government or to a local authority at the relevant date, and having become due and payable within the twelve months immediately before that date.
2. **Salary and Wages**: All wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any employee in respect of services rendered to the company and due for a period not exceeding four months within the 12 months immediately before the relevant date.
3. The debts enumerated in this section should rank equally among themselves and be paid in full, unless the assets are insufficient to meet them, in which case they should abate in equal proportions.
4. Employee does not include a workman.

LIST B CONTRIBUTORIES:

1. **Persons**: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.
2. **Liability**: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value Rs. 100 were paid up Rs. 60, the B List Contributory can be called up to pay a maximum of Rs. 40 only.
3. **Conditions**: Liability of B List Contributories will crystallize only
 - a. When the existing assets available with the liquidator are not sufficient to cover the liabilities;
 - b. When the existing shareholders fail to pay the amount due on the shares to the Liquidator.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

In Which sequence the following payments will be made while preparing the liquidator's statement of account?

1. Debenture holders
2. Unsecured creditors
3. Legal charges
4. Equity shareholders.
5. Preference shareholders.

(SM)

PROBLEM 2:

Amounts payable in winding-up of a company are as follows:

- Secured Creditors Rs. 1,25,000
- Workmen's Due Rs. 2,50,000

Show the payments made and treatment of balance in the following two instances:

(i) If the security realized is RS.2,00,000

(ii) If the security realized is RS.1,00,000

(SM)

PROBLEM 3:

A company went into liquidation whose creditors are Rs. 36,000. This amount of Rs. 36,000 includes Rs. 6,000 on account of wages of 15 men at Rs. 100 per month for 4 months, immediately before the date of winding up, Rs. 9,000 being the salaries of 5 employees at Rs. 300 per month for the previous 6 months, Rent for godown for the last six months amounting to Rs. 3,000; Income-tax deducted out of salaries of employees Rs.1,000. In addition it is estimated that the company would have to pay Rs. 3,000 as compensation to an employees for injuries suffered by him, which was contingent liability not accepted by the company and not included in above said creditors figure. Find the amount of Preferential Creditors.

(SM)

PROBLEM 4:

In a liquidation which commenced on April 2, 2011 certain creditors could not receive payments out of the realisation of assets and out of the contributions from “A” list contributories. The following are the details of certain transfers, which took place in 2010 and 2011.

Shareholders	Number of shares transferred at the date of ceasing to be member	Date of ceasing to be member	Creditors remaining unpaid and outstanding
X	1,500	1st March 2010	4,000
A	1,000	1st May 2010	6,000
B	1,500	1st July 2010	7,500
C	300	1st Nov. 2010	8,000
D	200	1st Feb. 2011	9,500

All the shares were Rs. 10 each, Rs. 6 paid up ignoring expenses of and remuneration to liquidators, etc., show the amount to be realised from the various persons listed above. **(SM)**

PROBLEM 5:

A liquidator is entitled to receive remuneration at 2% on the assets realized, 3% on the amount distributed to Preferential creditors and 3% on the payment made to unsecured creditors. The assets were realized for Rs. 50,00,000 against which payment was made as follows: Liquidation expenses Rs. 50,000 Secured Creditors Rs. 20,00,000 Preferential Creditors Rs. 1,50,000 The amount due to Unsecured creditors was Rs. 30,00,000 You are asked to calculate the total Remuneration payable to Liquidator. Calculation shall be made to the nearest multiple of a rupee. **(SM)**

PROBLEM 6:

Sky Ltd. went into liquidation on 1st April, 20X1. Following are the details regarding share capital of the company.

I. 20,000 Equity shares of Rs. 100 each, Rs. 75 paid up.

II. 30,000 Equity shares of Rs. 100 each, Rs. 40 paid up.

III. 80,000 Equity shares of Rs. 100 each, Rs. 65 paid up.

Surplus available with the Liquidator, after discharging all the liabilities is Rs. 20,00,000. Distribute this surplus money among different categories of shareholders. **(SM)**

PROBLEM 7:

Wind Ltd. went into liquidation on 31st March, 20X1. Following are the details regarding share capital of the company.

1. 15,000 Equity shares of Rs. 100 each, Rs. 90 paid up.
2. 40,000 Equity shares of Rs. 50 each, Rs. 25 paid up.
3. 2,00,000 Equity shares of Rs. 10 each, Rs. fully paid up.

Surplus available with the Liquidator, after payment of all the liabilities is Rs. 12,00,000. Distribute this surplus money among different categories of shareholders. **SM**

PROBLEM 8:

Omega Ltd. resolved on 31st March, 20X1 that the company be wound up voluntarily. The following was the trail balance extracted from its books as on the date:

PARTICULARS	Rs.	Rs.
Property, Plant and equipment	2,00,000	
Inventory	1,20,000	
Book debts	2,40,000	
Cash in Hand	40,000	
Profit and loss A/c (Dr. balance)	3,00,000	
1,000, 6% Preference shares of Rs. 100 each, fully paid		1,00,000
2,000 Equity shares of Rs. 100 each, fully paid		2,00,000
2,000 Equity shares of Rs. 100 each Rs. 75 paid up		1,50,000
Loan from bank (on security of stock)		1,00,000
Trade Payables		3,50,000
	9,00,000	9,00,000

The assets realized the following amounts (after all costs of realization and liquidator's commission amounting to Rs. 5,000 paid out of cash in hand).

PARTICULARS	Rs.
Property, Plant and equipment	1,68,000
Inventory	1,10,000
Trade receivables	2,30,000

Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable.

You are required to prepare Liquidator's Final statement of account. **SM**

PROBLEM 9:

M. Ltd. resolved on 31st December, 20X0 that the company be wound up voluntarily.

The following were the ledger balances extracted from its books as on that date:

	Rs.
Equity shares of Rs. 10 each	2,00,000
9% Preference shares of Rs. 10 each	1,00,000
Plant (less depreciation w/o Rs. 85,000)	2,15,000
Stock in trade	2,50,000
Trade receivables	55,000
Trade payables	75,000
Bank balance	74,000
Preliminary Expenses	6,000
Profit & Loss A/c (Dr. balance on 1st January, 20X0)	30,000
Outstanding Expenses (including mortgage interest)	25,000
4% Mortgage loan (secured by floating charge)	2,00,000

On 1st January, 20X1 the liquidator sold M. Ltd.'s Plant for Rs. 2,05,000 and stock intrade for Rs. 2,00,000. The sale was completed in January, 20X1 and the consideration satisfied as to Rs. 2,62,200 in cash and as to the balance in 6% Debentures of the purchasing company issued to the liquidator at a premium of 2%.

The remaining steps in the liquidation were as follows:

- (1) The liquidator realized Rs. 52,000 out of the book debts and the cost of collection amounted to Rs. 2,000.
- (2) The loan mortgage was discharged on 31st January, 20X1 along with interest from 31st July, 20X0. Trade payables were discharged subject to 2% and outstanding expenses excluding mortgage interest were settled for Rs. 2,000;
- (3) On 30th June 20X1 six month's interest on debentures was received from M. Ltd.
- (4) Liquidation expenses amounting to Rs. 3,000 and liquidator's remuneration of 3% on disbursements to members were paid on 30th June, 20X1 when:
 - (a) The preference shareholders were paid out in cash; and
 - (b) The debentures on M. Ltd. and the balance of cash were distributed rateably among the equity shareholders.

Prepare the Liquidator's Statement of Account showing the distribution.

(ILLUSTRATION-9 SM)

PROBLEM 10:

Confidence builders Ltd. gives the following ledger balances as on 30th September, 20X3:

	Rs.
Land and Building	1,20,000
Sundry current assets	3,95,000
Profit and loss account (Dr. balance)	38,500
Debenture issue expenses not written off	2,000
<u>Share Capital</u>	
Issued: 11% Preference shares of Rs. 10 each	1,00,000
10,000 equity shares of Rs. 10 each fully paid up	1,00,000
5,000 equity shares of Rs. 10 each, Rs. 7.50 per share paid up	37,500
13% Debentures	1,50,000
Mortgage Loan	80,000
Bank Overdraft	30,000
Creditors for trade	32,000
Income tax arrears: (assessment concluded in July 20X3)	
Assessment year 20X1-20X2	21,000
Assessment year 20X2-20X3	5,000

Mortgage loan was secured against land and buildings. Debentures were secured by a floating charge on all the other assets. The company was unable to meet the payments and therefore the debenture holders appointed a receiver for the debenture holders, he brought the land and buildings to auction and realized Rs. 1,50,000. He also took charge of sundry assets of value of Rs. 2,40,000 and realized Rs. 2,00,000. The bank overdraft was secured by a personal guarantee of two of the directors of the company and on the bank raising demand, the directors paid off the due from their personal resources. Costs incurred by the receiver were Rs. 2,000 and by the liquidator Rs. 2,800. The Receiver was not entitled to any remuneration but the liquidator was to receive 3% fee on the value of assets realized by him. Preference shareholders had not been paid dividend for the period after 30th September 20X1 and interest for the last half year was due to the debenture holders. Rest of the assets were realized at Rs. 1,00,000.

Prepare the accounts to be submitted by the Receiver and Liquidator.

SM

PROBLEM 11:

X Ltd. was ordered to be wound up on 31st March, 20X2 on which date the following balances were extracted from its books:

	Rs.
Goodwill	1,00,000
Building	3,50,000
Plant	5,50,000
Fixtures	23,000
Stock	38,000
Debtors	25,000
Cash	500
Profit and loss account (Dr. balance)	1,38,500
Share Capital: 10,000 Equity Shares of Rs. 100 each	10,00,000
5% Debentures (Secured by Floating charge on all assets)	1,60,000
Interest payable on these debentures	4,000
Bank overdraft (secured by hypothecation of stock)	25,000
Creditors	36,000

The amounts estimated to be realized are: Goodwill Rs. 1,000; Building Rs. 3,00,000; Plant Rs. 5,25,000; Fixtures Rs. 10,000; Stock Rs. 31,000; Debtors Rs. 20,000.

Creditors included Rs. 6,000 on account of wages of 15 men at Rs. 100 per month for 4 months immediately before the date of winding up ; Rs. 9,000 being the salaries of 5 employees at Rs. 300 per month for the previous 6 months; Rent for godown for the last six months amounting to Rs. 3,000; Income-tax deducted out of salaries of employees Rs. 1,000 and Directors Fees Rs. 500.

Three years ago, the debit balance in the Profit and Loss Account was Rs. 77,925 and since that date the accounts of the company have shown the following figures:

	Year	Year	Year
	31-3-20X0	31-3-20X1	31-3-20X2
	Rs.	Rs.	Rs.
Gross Profit	65,000	45,000	40,000
Wages and Salaries	40,500	36,000	34,400
Electricity and Water Tax	5,750	6,380	5,260
Debentures interest	8,000	8,000	8,000
Bad Debts	8,540	7,600	6,700
Depreciation	6,700		
Directors' Fees	1,000	1,000	1,000
Miscellaneous Expenses	10,500	7,265	7,980
Total	80,990	66,245	63,340

In addition it is estimated that the company would have to pay Rs. 5,000 as compensation to an employee for injuries suffered by him which was contingent liability not accepted by the company.

Prepare the Statement of Affairs and the Deficiency account.

(ILLUSTRATION 14 –SM)

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Explain Overriding preferential payments as per Companies Act, 2013.
2. Explain B List Contributories and the liability of contributories included in the list.
3. Write the LISTS which should accompany the Statement of Affairs, in case of a winding up by Court.

MCQs

1. Liability of B List Contributories will crystallize only When
 - (a) Existing assets available with the liquidator are not sufficient to cover the liabilities.
 - (b) Existing shareholders fail to pay the amount due on the shares to the Liquidator.
 - (c) both (a) and (b).

2. If Shares having Face Value Rs. 100 were paid up Rs. 70, the B List Contributory can be called up to pay
- (a) Maximum of Rs. 30 only.
 - (b) Maximum of Rs. 70 only.
 - (c) Maximum of 100 only.
3. In case of winding up of company by Tribunal, which statement is prepared to be presented to the Tribunal?
- (a) Statement of affairs.
 - (b) Statement of assets and liabilities.
 - (c) Statement of deficiency.
4. Which of the following will be treated as preferential creditors?
- (a) Govt. taxes.
 - (b) Trade Creditors.
 - (c) Unsecured loans.

6(A) AS-19 LEASES

OBJECTIVE:

The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

MEANING OF LEASE:

A Lease is an agreement whereby the Lessor (legal owner of an asset) conveys to the Lessee (another party) in return for a payment or series of periodic payments (Lease rents), the right to use an asset for an agreed period of time.

SCOPE:

The standard applies to all leases other than:

- (a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and
- (b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- (c) lease agreements to use lands

NOTE: AS-19 Is only applicable to Non-cancellable leases. It doesn't applicable to cancellable leases.

DEFINITIONS:

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 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.

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.

Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

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

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.

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).

Types of leases

For accounting purposes, leases are classified as:

- (i) Finance leases; and
- (ii) Operating leases.

Finance lease - A lease classified as Finance Lease if it transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred.

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, 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 specialized nature such that only the lessee can use it without major modifications being made.

Additional 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 and the lessor's losses associated with the cancellation are borne by the lessee;
- (b) If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease); and
- (c) If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

NOTE:

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 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term.

Accounting for Finance Leases (Books of lessee):

- (i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:
 - Fair value of leased asset at the inception of the lease
 - Present value of minimum lease payments from the standpoint of the lessee (present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used)
- (ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

- (iii) 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 AS 10 (Revised), Property, Plant and Equipment.
- (iv) 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.

Accounting for finance leases (Books of lessor):

- (i) 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. In a finance lease, the lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c.

- (ii) **a) Gross investment in Lease (GIL) = Minimum Lease Payments (MLP) + Unguaranteed Residual value (UGR)**

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

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

- (iii) The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

$(PV \text{ of MLP} + PV \text{ of UGR}) = \text{Fair Value.}$

The above definitions imply that:

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

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

- (iv) Since the sale and receivables are recognised at net investment in lease, which is equal to fair value:

Profit recognised at the inception of lease = Fair Value – Cost

Total earning of lessor = GIL – Cost

$= (GIL - \text{Fair Value}) + (\text{Fair Value} - \text{Cost})$

$= \text{Unearned Finance Income} + (\text{Fair Value} - \text{Cost})$

Manufacturer or dealer lessor:

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.

Accounting for Operating Leases (Books of Lessee):

1. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight- line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.
2. Lease payments may be tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, AS 19 requires lessees to recognise operating lease payments as expense in the statement of profit and loss on a straight- line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Accounting for Operating Leases (Books of Lessor):

- (i) The lessor should present an asset given under operating lease as fixed assets in its balance sheets.
- (ii) 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.
- (iii) Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.
- (iv) The impairment losses on assets given on operating leases are determined and treated as per AS 28.
- (v) A manufacturer or dealer lessor should recognise the asset given on operating lease as fixed asset in their books by debiting concerned Fixed Asset A/c and crediting Cost of Production /

Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales.

Sale and Leaseback:

1. The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer.
2. Lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package.
3. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.
4. 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.
5. 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.

Sale price established at fair value (paragraph 50)	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fairvalue
Profit	No profit	Recognise profit immediately	Not applicable
Loss	No loss	Not applicable	Recognise loss immediately
Sale price below fair value (paragraph 50)			

Profit	No profit	Recognise profit immediately	No profit (note 1)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)
Sale price above fair value (paragraph 50)			
Profit	Defer and amortise profit	Defer and amortise profit	Defer and amortise profit (note 2)
Loss	No loss	No loss	(note 1)

Note 1 These parts of the table represent circumstances that would have been dealt where the carrying amount of an asset is greater than fair value then it should be written down to fair value .

Note 2 The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

Classify the following into either operating or finance lease:

- (i) Lessee has option to purchase the asset at lower than fair value, at the end of lease term;
- (ii) Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;
- (iii) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;
- (iv) Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y". **(SM)**

PROBLEM 2:

Annual lease rents = Rs. 50,000 at the end of each year
 Lease period. = 5 years;
 Guaranteed residual value = Rs. 25,000
 Unguaranteed residual value (UGR) = Rs. 15,000
 Fair Value at the inception (beginning) of lease = Rs. 2,00,000

Calculate Interest rate implicit in the lease?

PROBLEM 3:

Annual lease rents = Rs. 50,000 at the end of each year.
 Lease period = 5 years;
 Guaranteed residual value = Rs. 25,000
 Unguaranteed residual value (UGR) = Rs. 15,000
 Fair Value at the inception (beginning) of lease = Rs. 2,00,000
 Interest rate implicit on lease is =12.6%.
 Record the Journal entry in the books of Lessee at the inception of Finance lease?

PROBLEM 4:

Using data for Problem 3 and assuming zero residual value, calculate finance charge included in lease rental over lease period?

PROBLEM 5:

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

Lease term = 4 years

Fair value at inception of lease = Rs. 20,00,000

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

Guaranteed residual value = Rs. 1,25,000

Expected residual value = Rs. 3,75,000

SATYARAJU, FCA, DISA, B.COM

Casatyaraju2016@gmail.com

Implicit interest rate = 15%

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

Calculate the value of the lease liability as per AS-19 and disclose impact of this on Balance sheet and Profit & loss account at the end of year 1. **(SM)**

PROBLEM 6:

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

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

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

Ascertain Unearned Finance Income.

(SM)

PROBLEM 7:

Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year1, 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are RS.25,000, 45,000 and 50,000 respectively.

Calculate lease rent to be recognised in each year and also provide Journal entries in the books of Lessee for year 1 on the assumption that lease is operating lease.

PROBLEM 8:

A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost ` 1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate.

Compute the following:

- (i) Annual Lease Rent
- (ii) Lease Rent income to be recognized in each operating year and
- (iii) Depreciation for 3 years of lease.

(SM-PRACTICAL PROBLEM 16)

PROBLEM 9:

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

1. Sale price of Rs. 50 lakhs is equal to fair value.
2. Fair value is Rs. 60 lakhs.
2. Fair value is Rs. 45 lakhs and sale price is Rs. 38 lakhs.
3. Fair value is Rs. 40 lakhs and sale price is Rs. 50 lakhs.
4. Fair value is Rs. 46 lakhs and sale price is Rs. 50 lakhs
5. Fair value is Rs. 35 lakhs and sale price is Rs. 39 lakhs.

(SM)

CA SATYA RAJU

6(b) AS-18 RELATED PARTY DISCLOSURES

OBJECTIVE:

1. AS 18 prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties.
2. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

SCOPE:

1. Related party disclosure requirements as laid down in AS 18 do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.
2. No disclosure is required in consolidated financial statements in respect of intra-group transactions.
3. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Definitions:

Related party transaction:

A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Control:

- (a) ownership, directly or indirectly, 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, or
- (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

Significant influence:

1. Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies. It may be exercised in several ways, for example, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information.

2. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise.

Key Management Personnel:

Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Example: In the case of a company, the managing directors, whole time directors, manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Relative In relation to an individual

Means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

Related party:

AS 18 deals only with related party relationships described in (a) to (e) below:

- a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).
- b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.
- c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.
- d. Key management personnel and relatives of such personnel and
- e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence.
This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

In the context of AS 18, the following are deemed not to be related parties:

1. Two companies simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings).
2. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and
3. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):
 - a. Providers of finance
 - b. Trade unions
 - c. Public utilities
 - d. Government departments and government agencies including government sponsored bodies.

Disclosure:

- 1.** Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.
- 2.** If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:
 - (i) The name of the transacting related party;
 - (ii) A description of the relationship between the parties;
 - (iii) A description of the nature of transactions;
 - (iv) Volume of the transactions either as an amount or as an appropriate proportion;
 - (v) Any other elements of the related party transactions necessary for an understanding of the financial statements;

PROBLEMS FOR DISCUSSION

PROBLEM 1:

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

(SM)

PROBLEM 2:

Narmada Ltd. sold goods for Rs. 90 lakhs to Ganga Ltd. during financial year ended 31-3-20X1. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?**(SM)**

PROBLEM 3:

Mr. Raj a relative of key management personnel received remuneration of Rs. 2,50,000 for his services in the company for the period from 1.4.20X1 to 30.6.20X1. On 1.7.20X1, he left the service. Should the relative be identified as at the closing date i.e. on 31.3.20X2 for the purposes of AS 18? **(SM)**

PROBLEM 4:

X Ltd. sold goods to its associate Company during the 1st quarter ending 30.6.20X1. After that, the related party relationship ceased to exist. However, goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction. **(SM)**

PROBLEM 5:

Arohi Ltd. sold goods for Rs. 90 lakhs to Anya Ltd. during financial year ended 31-3-20X1. The Managing Director of Arohi Ltd. own 100% of Anya Ltd. The sales were made to Anya Ltd. at normal selling prices followed by Arohi Ltd. The Chief accountant of Arohi Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct? Comment in accordance with AS 18. **(SM)**

PROBLEM 6:

- (a) Omega Bank Limited holds 25 per cent of the voting power of B Limited. Omega Bank Limited also provides finance by way of a loan to B Limited at market rates of interest, on account of which, Omega Bank Limited would have the power to nominate one person to the board of directors of B Limited. Any major transactions proposed to be entered into by B Limited would need the consent of Omega Bank Limited. Would Omega Bank Limited be considered as related party for B Ltd. (reporting enterprise)?
- (b) A Limited has two Associates, B Limited and C Limited, and owns 25 per cent of the voting power of B Limited and 30 per cent of the voting power of C Limited. Would B Limited be considered a related party for the purpose of financial statements of C Limited? **(RTP-NOV 2021-QUESTION17)**

PROBLEM 7:

- (i) Khushi Limited enter into an agreement with Mr. Happy for running a business for a fixed amount payable to the later every year. The contract states that the day-to-day management of the business will be handled by Mr. Happy, while all financial and operating policy decisions are taken by the Board of Directors of the Company. Mr. Happy does not own any voting power in Khushi Limited.
- (ii) Shri Bhanu a relative of key management personnel received remuneration of ` 3,50,000 for his services in the company for the period from 1 st April, 2020 to 30th June, 2020. On 1st July, 2020, he left the service.

You are required to suggest how the above transactions will be treated as at the closing date i.e. on 31st March, 2021 for the purposes of AS 18- Related Party Disclosures.**(JULY 2021 QP-QUESTION-1d)**

6(C) AS 17 SEGMENT REPORTING

OBJECTIVE:

The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates.

Such information helps users of financial statements:

- (a) Better understand the performance of the enterprise;
- (b) Better assess the risks and returns of the enterprise; and
- (c) Make more informed judgements about the enterprise as a whole.

SCOPE:

1. AS 17 is mandatory in respect of non-SMCs (and level I entities in case of non-corporates). Other entities are encouraged to comply with AS. An enterprise should comply with the requirements of this Standard fully and not selectively.
2. AS 17 should be applied in presenting general purpose financial statements. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements.

Business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

Factors that should be considered in determining whether products or services are related include:

- a. The nature of the products or services
- b. The nature of the production processes
- c. The type or class of customers for the products or services
- d. The methods used to distribute the products or provide the services
- e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities

Geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. A

geographical segment may be a single country, a group of two or more countries, or a region within a country.

The definition allows geographical segments to be based on either:

- a. The location of production or service facilities and other assets of an enterprise; or
- b. The location of its customers.

Factors that should be considered in identifying geographical segments include:

- a. Similarity of economic and political conditions.
- b. Relationships between operations in different geographical areas.
- c. Proximity of operations.
- d. Special risks associated with operations in a particular area.
- e. Exchange control regulations and
- f. The underlying currency risks.

Reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by AS 17.

Identifying Reportable Segments (Quantitative Thresholds):

A business segment or geographical segment should be identified as a reportable segment if:

- a. Its revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue, external and internal, of all segments; or
- b. Its segment result, whether profit or loss, is 10% or more of –
 - (i). The combined result of all segments in profit, or
 - (ii). The combined result of all segments in loss,
 Whichever is greater in absolute amount; or
- c. Its segment assets are 10% or more of the total assets of all segments.
- d. If total external revenue attributable to reportable segments constitutes less than 75% of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10% thresholds, until at least 75% of total enterprise revenue is included in reportable segments.

NOTES:

1. A business segment or a geographical segment which is not a reportable segment as per above paragraph, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise.

2. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10% thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10% thresholds.

Primary and Secondary Segment Reporting:

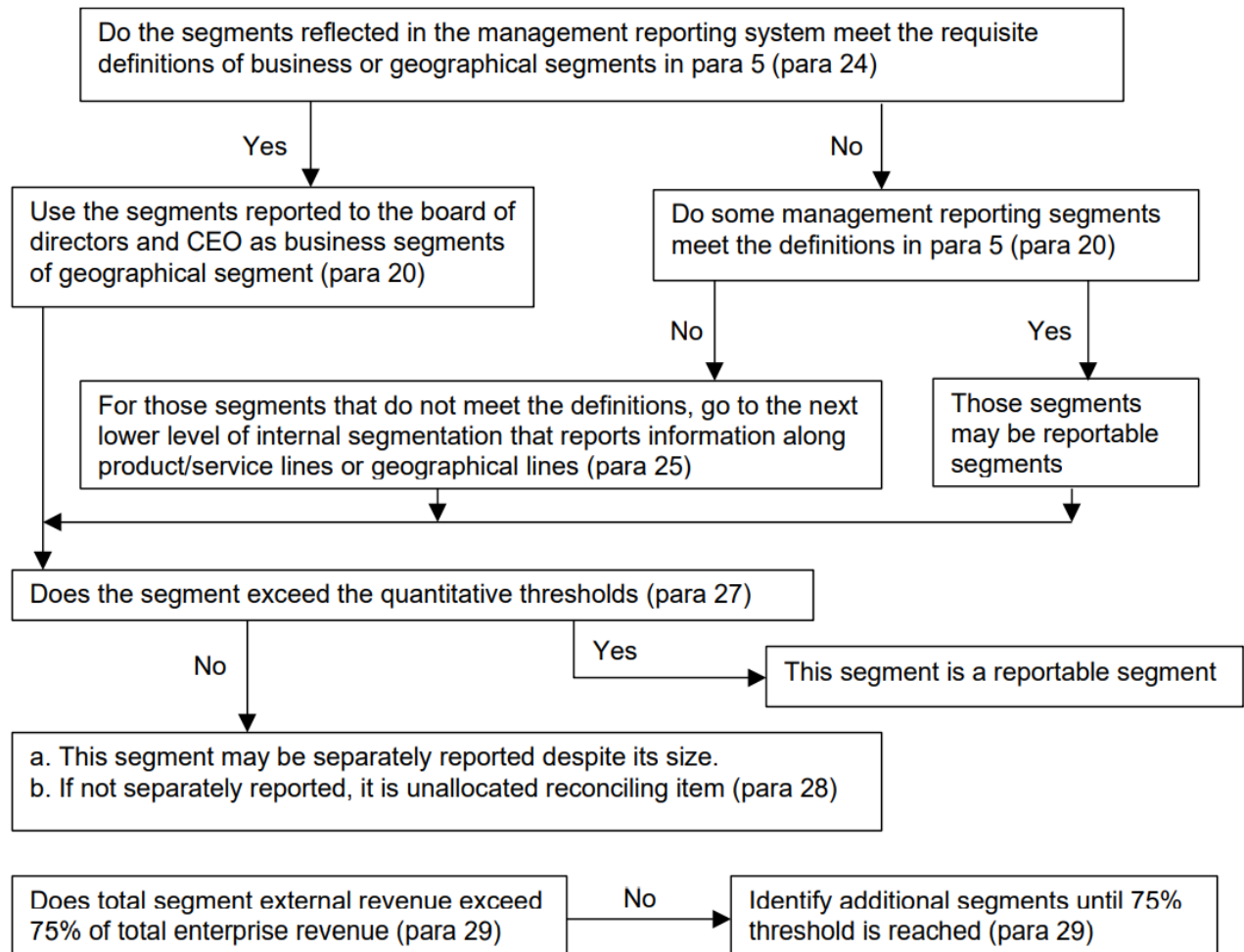
The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

1. If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically.
2. If the risks and returns of the enterprise are by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment information should be geographical segments, with secondary information reported for groups of related products and services.

Notes:

Generally Business and Geographical segments are determined on the basis of internal financial reporting to the board of directors and the chief executive officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered.

- a. If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, then For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions(internally reported segment that meets the definition should not be further segmented) and
- b. If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.



Primary Segment Information:

An enterprise should disclose the following for each primary reportable segment:

- a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
- b. Segment result;
- c. Total carrying amount of segment assets;
- d. Total amount of segment liabilities;
- e. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
- f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
- g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets that were included in segment expense and, therefore, deducted in measuring segment result.

h. An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements.

- segment revenue should be reconciled to enterprise revenue;
- segment result should be reconciled to enterprise net profit or loss;
- segment assets should be reconciled to enterprise assets; and
- segment liabilities should be reconciled to enterprise liabilities.

Segment revenue is the aggregate of

- (i) The portion of enterprise revenue that is directly attributable to a segment,
- (ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and
- (iii) Revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and
- c. Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

- (i) The expense resulting from the operating activities of a segment that is directly attributable to the segment, and
- (ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment,
- (iii) Including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature.
- c. Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- d. Income tax expense; and

- e. General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment result is segment revenue less segment expense.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

Segment assets do not include:

- income tax assets;
- assets used for general enterprise or head-office purposes.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

Segment liabilities do not include:

- income tax liabilities;
- borrowings and other liabilities that are incurred for financing rather than operating purposes.

Treatment of Interest for determining Segment Expense:

1. The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories.
2. In case interest is included as a part of the cost of inventories where it is so required as per AS 16, read with AS 2 (Revised), and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest should be disclosed by way of a note to the segment result.

Segment Accounting Policies:

1. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies. Segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.
2. Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. AS 17 does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that
 - a. the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and
 - b. the basis of measurement for this additional information is clearly described.
3. In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

Secondary Segment Information:

1. 1.If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:
 - a. Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10% or more of enterprise revenue;
 - b. The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments; and
 - c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments.

2. If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each reportable business segment.
- Segment revenue from sales to external customers is 10% or more of enterprise revenue of all business segments.
 - segment assets are 10% or more of the total assets of all business segments
 - The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by each business segment whose segment assets are 10% or more of the total assets of all Business segments.

Other Disclosures:

1. Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Some changes in accounting policies may relate specifically to segment reporting. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise.

Examples:

- changes in identification of segments; and
 - changes in the basis for allocating revenues and expenses to segments.
 - Pricing of Inter segment transfers.
2. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effects of the change, if reasonably determinable.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why? **(SM)**

PROBLEM 2:

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

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

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

PROBLEM 3:

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

PROBLEM 4:

A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct or not in line with the provisions of AS 17? **(SM)**

PROBLEM 5:

- (A) Company A is engaged in the manufacture of chemicals. The company manufactures five types of chemicals that have different applications. Can this company include more than one type of chemical in a single business segment? Comment.
- (B) Is an enterprise required to disclose changes in the basis of allocation of revenue and expenses to segments? Explain. **(RTP Nov 2021)**

PROBLEM 6:

Prepare a segmental report for publication in Diversifiers Ltd. from the following details of the company's three divisions and the head office:

PARTICULARS	Rs. (Rs.000)
<u>Forging Shop Division</u>	
Sales to Bright Bar Division	4,575
Other Domestic Sales	90
Export Sales	<u>6,135</u>
	<u>10,800</u>
<u>Bright Bar Division</u>	
Sales to Fitting Division	45
Export sales to Rwanda	<u>300</u>
	<u>345</u>
<u>Fitting Division</u>	
Export sales to Maldives	<u>270</u>

Particulars	Head Office Rs. (Rs.000)	Foreign shop division Rs. (Rs.000)	Bright bar Division Rs. (Rs.000)	Fitting Division Rs. (Rs.000)
Pre Tax operating result		240	30	(12)
Head office cost reallocated		72	36	36
Interest costs		6	8	2
Fixed assets	75	300	60	180
Net current assets	72	180	60	135
Long term liabilities	57	30	15	180

(SM)

6(D) AS 26 INTANGIBLE ASSETS

OBJECTIVE:

1. The objective of AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard.
2. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. AS 26 also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

SCOPE:

AS 26 does not apply to

1. Intangible assets that are covered by another Accounting Standard
 - a. intangible assets held by an enterprise for sale in the ordinary course of business (AS 2)
 - b. deferred tax assets (AS 22)
 - c. leases that fall within the scope of AS 19
 - d. goodwill arising on an amalgamation (AS 14) and goodwill arising on consolidation (AS 21)
2. Financial assets.
3. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and
4. Intangible assets arising in insurance enterprises from contracts with policyholders.

DEFINITIONS:

Intangible Assets

An intangible asset is

- an identifiable
- non-monetary asset
- without physical substance
- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

EXAMPLES: 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), computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier

relationships, customer loyalty, market share and marketing rights, Goodwill arises on acquisition or is internally generated.

An asset is a resource:

- (a) controlled by an enterprise as a result of past events; and
- (b) from which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Non-monetary assets are assets other than monetary assets.

NOTES:

1. Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise should be required. If an item covered by AS 26 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.
2. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.
3. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant.

Example: computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability:

1. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill.

2. An intangible asset can be clearly distinguished from goodwill if the asset is separable which means that 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.
3. Separability is not a necessary condition for identifiability. If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

1. 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.
2. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality.
3. Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise as employees may leave the enterprise anytime or even loyal customers may decide to purchase goods and services from other suppliers. Hence, these items don't even qualify as intangible asset as per the definition given in AS 26.

Future Economic Benefits: The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

Recognition and Initial Measurement:

1. The recognition of an item as an intangible asset requires meets the definition of an intangible asset and recognition criteria set out as below.
 - a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
 - b. The cost of the asset can be measured reliably.
2. An intangible asset should be measured initially at cost.

cost of an intangible asset

a) purchase consideration is in the form of cash or other monetary assets:

- its purchase price,
- any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and
- any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

b) 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.

c) Acquisition by way of a Government Grant:

An intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant is recognised at a nominal value or at the acquisition cost, as appropriate.

d) Acquisition by way Exchanges of assets:

An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10. The cost of such an item is measured at fair value unless

- (i). the exchange transaction lacks commercial substance or
- (ii). the fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

In that case acquired Intangible asset is measured at carrying amount of the asset given up.

e) Internally Generated Intangible Assets:

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

- Research Phase &
- Development Phase

NOTE: Internally generate 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.

Research Phase: Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Expenditure on research or on the research phase should be recognised as an expense when it is incurred. No intangible asset arising from research or from the research phase should be recognised.

Examples of research activities are:

- a. Activities aimed at obtaining new knowledge.
- b. The search for, evaluation and final selection of, applications of research findings or other knowledge.
- c. The search for alternatives for materials, devices, products, processes, systems or services;
- d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase: Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development phase should be recognised if, and only if, an enterprise can demonstrate all of the following:

- a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- b. Its intention to complete the intangible asset and use or sell it.
- c. Its ability to use or sell the intangible asset.
- d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and
- f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

- a. The design, construction and testing of pre-production or pre-use prototypes and models.
- b. The design of tools, jigs, moulds and dies involving new technology.

- c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and
- d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

NOTE: 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.

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.

Cost includes

- a. Expenditure on materials and services used or consumed in generating the intangible asset.
- b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.
- c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licenses that are used to generate the asset and
- d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset, these should be expensed off in profit and loss account:

- a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.
- b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and
- c. Expenditure on training the staff to operate the asset.

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 expenditure is recognised as an expense when it is incurred.

- a. Expenditure on research is always recognised as an expense when it is incurred.
- b. Expenditure on start-up activities. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs)
- c. Expenditure on training activities
- d. Expenditure on advertising and promotional activities; and
- e. Expenditure on relocating or re-organising part or all of an enterprise.

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.

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 Period

- a. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use.
- b. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. AS 26 adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.
- c. 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:
 - (i) Amortises the intangible asset over the best estimate of its useful life.

- (ii) Discloses the reasons why the presumption is rebutted and the factors that played a significant role in determining the useful life of the asset.

EXAMPLE: An enterprise has purchased an exclusive right to generate hydroelectric power for 60 years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least 60 years. The enterprise amortises the right to generate power over 60 years, unless there is evidence that its useful life is shorter.

Amortisation Method:

1. 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.
2. Some of Such methods are
 - straight-line method,
 - Diminishing balance method and
 - Unit of production method.
3. 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.

Retirements and Disposals:

1. An intangible asset should be derecognised (eliminated from the balance sheet) if
 - disposed or
 - when no future economic benefits are expected from its use and ready for disposal.
2. Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Disclosure:

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

1. The useful lives or the amortisation rates used.

2. The amortisation methods used.
3. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
4. A reconciliation of the carrying amount at the beginning and end of the period.

CA SATYA RAJU

PROBLEMS FOR DISCUSSION

PROBLEM 1:

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was Rs. 10 lacs, of which Rs. 9 lacs was incurred before 1 December 20X1 and 1 lac was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 5 lacs. During the year 20X2, expenditure incurred is Rs. 20 lacs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 19 lacs.

Calculate carrying amount of Intangible Asset at the end of 2011 and 2012. **(SM-EXAMPLE)**

PROBLEM 2:

An enterprise has purchased an exclusive right to operate a toll motorway for 30 years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least 30 years. Can enterprise amortize the intangible asset over period of 30 years? Give your comment. **(SM-EXAMPLE)**

PROBLEM 3:

ABC Ltd. developed know-how by incurring expenditure of Rs. 20 lakhs, The know-how was used by the company from 1.4.20X1. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.20X8. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.20X8. **(SM)**

PROBLEM 4:

The company had spent Rs. 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 20X1-20X2, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 20X2. **(SM)**

PROBLEM 5:

A company with a turnover of Rs. 250 crores and an annual advertising budget of Rs. 2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of Rs. 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of Rs. 2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct? **(SM)**

PROBLEM 6:

Swift Ltd. acquired a patent at a cost of Rs. 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at Rs. 10,00,000 per

annum. The company had amortized the patent at 1,00,000 per annum in first two years on the basis of economic benefits derived from the product manufactured under the patent. After two years it was found that the product life-cycle may continue for another 5 years from then. The patent was renewable and Swift Ltd. got it renewed after expiry of five years. The net cash flows from the product during these 5 years were expected to be Rs. 36,00,000, Rs. 46,00,000, Rs. 44,00,000, Rs. 40,00,000 and Rs. 34,00,000.

Find out the amortization cost of the patent for each of the years.

(SM)

PROBLEM 7:

AB Ltd. launched a project for producing product X in October, 20X1. The Company incurred Rs. 20 lakhs towards Research. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years. Advise the Company as per the applicable Accounting Standard.

(SM)

PROBLEM 8:

During 20X1-X2, an enterprise incurred costs to develop and produce a routine low risk computer software product, as follows:

Particulars	Rs.
Completion of detailed program and design (Phase 1)	50,000
Coding and testing (Phase 2)	40,000
Other coding costs (Phase 3 & 4)	63,000
Testing costs (Phase 3 & 4)	18,000
Product masters for training materials (Phase 5)	19,500
Packing the products (1500 units) (Phase 6)	16,500

After completion of phase 2, it was established that the product is technically feasible for the market. You are required to state how the above referred cost to be recognized in the books of accounts.

(SM)

PROBLEM9:

X Ltd. carried on business of manufacturing of Bakery products. The company has two trademarks "Sun" and "Surya". One month before, the company comes to know through one of the marketing managers that both trademarks have allegedly been infringed by other competitors engaged in the same field. After investigation, legal department of the company informed that it had weak case on trademark "Sun" and strong case in regard to trademark "Surya". X Ltd. incurred additional legal fees to stop infringement on both trademarks. Both trademarks have a remaining legal life of 10 years. How should X Ltd. account for these legal costs incurred relating to the two trademarks?

(RTP-NOV-2020)

6(E).PROVISIONS,CONTINGENT LIABILITIES

AND CONTINGENT ASSETS

OBJECTIVE:

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

SCOPE:

AS 29 should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than

1. Those resulting from financial instruments that are carried at fair value;
2. Those resulting from executory contracts except where the contract is onerous;
3. Those arising in insurance enterprises from contracts with policy-holders; and
4. Those covered by another Accounting Standard. Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of AS 29.

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

Onerous contracts are contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. If an enterprise has a contract that is onerous, the present obligation under the contract is recognised and measured as a provision as per this Standard.

Example: a lease on a property that is no longer necessary but cannot be sublet.

PROVISION is a liability which can be measured only by using a substantial degree of estimation.

A provision should be recognised when:

1. An enterprise has a **present obligation** as a result of a **past event**;

2. It is **probable that an outflow of resources** embodying economic benefits will be required to settle the obligation; and
3. A **reliable estimate** can be made of the amount of the obligation.

If all the above conditions are met, then only provision should be recognised.

Example:

XYZ is in mining business. It is operating in a country where XYZ is legally bound to clean and restore the environment on expiry of license after 10 years. XYZ can reliably estimate the amount required to restore the environment caused by the mining business. Since it is a present obligation which cannot be avoided resulted from past event, it is probable that resources will flow out of business to settle the same and estimate can be measured reliably. XYZ is required to recognize a provision for the same.

Present Obligation: an obligation is a present obligation if, based on the evidence available (e.g., the opinion of experts), its existence at the balance sheet date is considered probable, i.e., more likely than not.

Past Event:

1. 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.
2. 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.
3. 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:

- i. 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.
- ii. Decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused.

4. No provision is recognised in case 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, by changing its method of operation etc. It has no present obligation for that future expenditure and no provision is recognised.

Example: Fitting smoke filters in a certain type of factory.

5. 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. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

Probable Outflow of Resources Embodying Economic Benefits:

For a provision 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 AS 29, an outflow of resources is regarded as probable if the probability that the outflows will occur is greater than the probability that it will not.

Reliable Estimate of the Obligation:

Provisions require a greater degree of estimation than most other items. AS 29 concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability will, instead, be disclosed as a contingent liability.

Measurement -Best Estimate:

1. 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.
2. 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.
3. The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment.

CONTINGENT LIABILITY:

A Contingent liability is:

1. 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
2. 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.

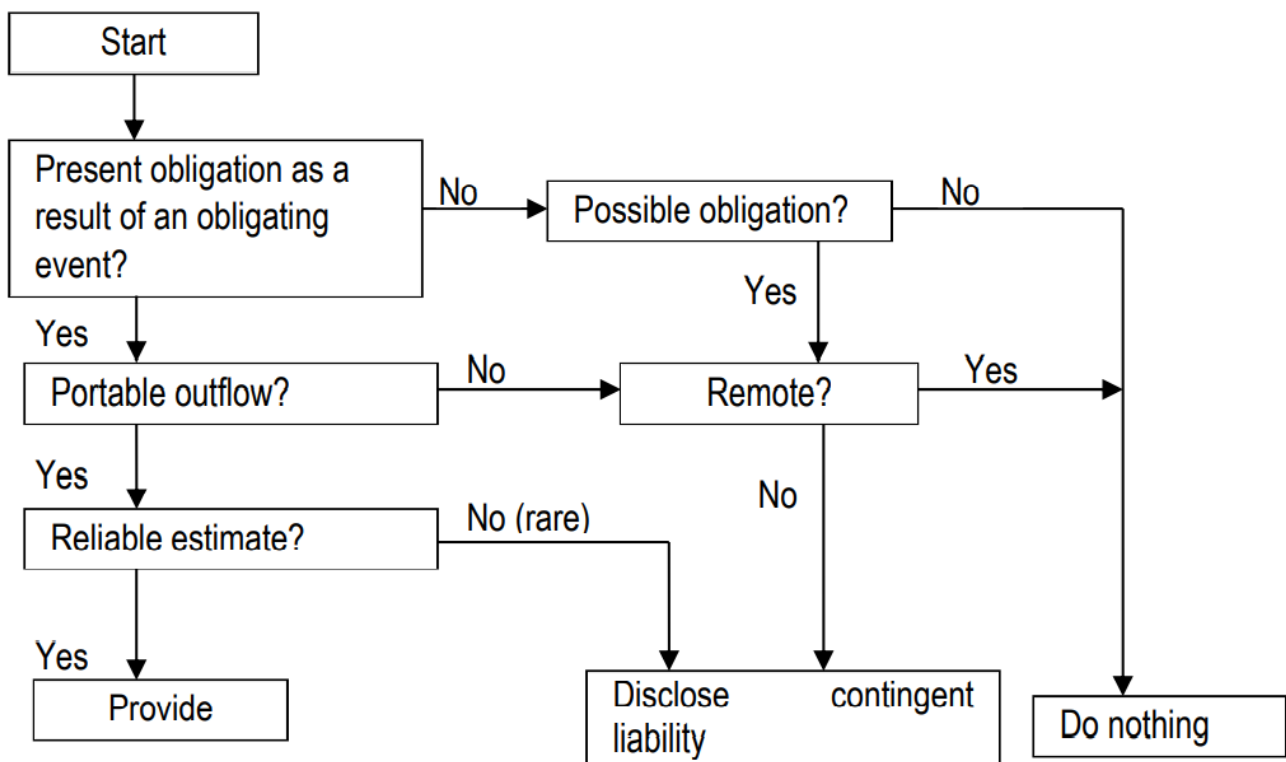
Example:

A customer of XYZ has filed a case against them for providing them wrong product and not returning the same. XYZ has taken legal advice from their lawyer who believes it is not probable yet that resources may be required to settle the same. Since it is not meeting all the criteria of provision, it will be treated as contingent liability and will just be disclosed in the notes.

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.

Accounting treatment:

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

DECISION TREE**Contingent Asset:**

Contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

EXAMPLE: claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

Accounting treatment:

An enterprise should not recognise a contingent asset and it is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

Application of the Recognition and Measurement Rules:**1. Reimbursements:**

- i. An, enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:
 - An insurance contract arranged to cover a risk;

- An indemnity clause in a contract; or
 - A warranty provided by a supplier.
- ii. The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. The reimbursement should be recognised as an Asset when, and only when, it is virtually certain that reimbursement will be received & if the enterprise settles the obligation. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
 - iii. In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.
 - iv. 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.

2. FUTURE OPERATING LOSSES:

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

3. RESTRUCTURING:

- i. 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.

EXAMPLES:

- 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
- d. Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

- ii. A provision for restructuring costs is recognised only when the recognition criteria for provisions are met. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.
- iii. 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.
- iv. Some expenses relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date.
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.

Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

A provision should be used only for expenditures for which the provision was originally recognised. Only expenditures that relate to the original provision are adjusted against it.

Disclosure:

For each class of provision, an enterprise should disclose:

- (a) The carrying amount at the beginning and end of the period;
- (b) Additional provisions made in the period, including increases to existing provisions;
- (c) Amounts used (i.e. incurred and charged against the provision) during the period; and
- (d) Unused amounts reversed during the period.

For each class of contingent liability, an enterprise should disclose:

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose a brief description of the nature of the contingent liability and, where practicable:

- (a) An estimate of its financial effect,
- (b) An indication of the uncertainties relating to any outflow;

PRACTICAL CASES FOR DISCUSSION

CASE 1: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

ANSWER:

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation. An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole.

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date

CASE 2: Contaminated Land - Legislation Virtually

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2021 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

ANSWER:

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up

CASE 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

ANSWER:

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

CASE4: Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

ANSWER:

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund.

Conclusion - A provision is recognised for the best estimate of the costs of refunds

CASE 5: Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

ANSWER:

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters

(b) At the balance sheet date of 31 March 2006**ANSWER:**

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

CASE 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

ANSWER:

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised

CASE 7: A Single Guarantee

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

ANSWER:**(a) At 31 March 2005**

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2005.

Conclusion - No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote .

(b) At 31 March 2006**ANSWER:**

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable .

CASE 8: A Court Case

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

ANSWER:**(a) At 31 March 2005**

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote

(b) At 31 March 2006

ANSWER:

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation. An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation

CASE 9A: Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

ANSWER:

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised. The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

CASE9B: Refurbishment Costs – Legislative Requirement

An airline is required by law to overhaul its aircraft once every three years.

ANSWER:

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised. The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in CASE 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

CASE10: An Onerous Contract

An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2005 the enterprise relocates its operations to a new factory. The lease on the old factory

continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

ANSWER:

Present obligation as a result of a past obligating event-The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation. An outflow of resources embodying economic benefits in settlement- When the lease becomes onerous, an outflow of resources embodying economic benefits is probable, (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

Conclusion-A provision is recognised for the best estimate of the unavoidable lease payments.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

At the end of the financial year ending on 31st December, 20X1, 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 (Rs.)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	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. **(SM)**

PROBLEM 2:

EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 20X2. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 20X1-X2 has been completed on 14th February, 20X4 with a demand of Rs. 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 20X2 whereby the labour union has accepted a revision in wage from June, 20X1. The agreement provided that the hike till May, 20X2 will

not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 20X2. **(SM)**

PROBLEM 3:

An organization operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten percent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted. With reference to AS-29, how would you deal with this in the annual accounts of the company at the Balance Sheet date? **(SM-PRACTICAL QUESTION 17)**

PROBLEM 4:

A company, incorporated as NPO under the Companies Act, is having main objective to promote the trade by organizing trade fairs / exhibitions. While organizing the trade fair and exhibitions, it decided to charge 5% contingency charges for the participants/outside agencies on the income received from them by the company, while in the case of fairs organized by outside agencies, 5% contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organized by the company itself are inbuilt in the space rent charged from the participants. Both are credited to Income and Expenditure Account of the company.

The intention of levying these charges is to meet any unforeseen liability, which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life to visitors/exhibitors, etc., due to fire, terrorist attack, stampede, natural calamities and other public and third party liability. The chances of occurrence of these events are high because of large crowds visiting the fair. The decision to levy 5% contingency charges was based on assessment only as actual liability on this account cannot be estimated.

The accounting treatment and disclosure was made by the company in its financial statements as: (i) 5% contingency charges are treated as income and matching provision for the same is also being made in accounts and (ii) suitable disclosure to this effect is also made in the notes forming part of accounts.

You are required to comment whether creation of provision for contingencies considering the facts and circumstances of the case is required in line with AS 29. **[RTP NOV 2021-20(b)]**

PROBLEM 5:

Alpha Ltd. has entered into a sale contract of ` 7 crores with Gamma Ltd. during 2018-19 financial year. The profit on this transaction is ` 1 crore. The delivery of goods to take place during the first month of 2019-20 financial year. In case of failure of Alpha Ltd. to deliver within the schedule, a compensation of ` 2 crores is to be paid to Gamma Ltd. Alpha Ltd. planned to manufacture the goods during the last month of 2018-19 financial year. As on balance sheet date (31.3.2019), the goods were not manufactured and it was unlikely that Alpha Ltd. will be in a position to meet the contractual obligation. You are required to advise Alpha Ltd. on requirement of provision for contingency in the financial statements for the year ended 31st March, 2019, in line with provisions of AS 29? **[RTP NOV 2020-20(b)]**

PROBLEM 6:

A Ltd. provides after sales warranty for two years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period.

Less than 1 year: 2% provision More than 1 year: 3% provision

The company has raised invoices as under :

<u>Invoice Date</u>	<u>Amount</u>
11th Feb, 2017	60,000
25th Dec, 2017	40,000
04th Oct, 2018	1,35,000

Calculate the provision to be made for warranty under AS-29 as at 31st March, 2018 and 31 st March, 2019. Also compute amount to be debited to P & L account for the year ended 31st March, 2019.

(NOV 2019-1(a)-QP)

6(F) AS 24 DISCONTINUING OPERATIONS

OBJECTIVE:

The objective of AS 24 is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

Discontinuing Operation:

A discontinuing operation is a component of an enterprise:

- a. That the enterprise, pursuant to a single plan, is:
 1. Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
 2. Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
 3. Terminating through abandonment and
- b. That represents a separate major line of business or geographical area of operations.
- c. That can be distinguished operationally and for financial reporting purposes.

Separate major line of business or geographical area of operations

- A reportable business segment or geographical segment as defined in AS 17 'Segment Reporting', would normally satisfy criteria and it would represent a separate major line of business or geographical area of operations.
- A part of such a segment may also satisfy criteria and it would represent a separate major line of business or geographical area of operations
- For an enterprise that operates in a single business or geographical segment which does not report segment information, a major product or service line may also satisfy the criteria.

NOTE:

An enterprise may terminate an operation by abandonment without substantial sales of assets. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

Examples of activities that do not treated as Discontinuing operations:

- a. Gradual or evolutionary phasing out of a product line or class of service.
- b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.

- c. Shifting of some production or marketing activities for a particular line of business from one location to another and
- d. Closing of a facility to achieve productivity improvements or other cost savings.

Initial Disclosure event

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

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

Recognition and Measurement

For recognising and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

Presentation and Disclosure

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

- a. A description of the discontinuing operation(s)
- b. The business or geographical segment(s) in which it is reported as per AS 17
- c. The date and nature of the initial disclosure event.
- d. The date or period in which the discontinuance is expected to be completed if known or determinable
- e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled
- f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period
- g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto
- h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period

Restatement of prior periods

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

PROBLEMS FOR DISCUSSION

PROBLEM 1

What are discontinuing operations as per AS 24? Should an enterprise include prescribed information relating to a discontinuing operation in its financial statements? **(RTP NOV 2021-QUESTION 19(a))**

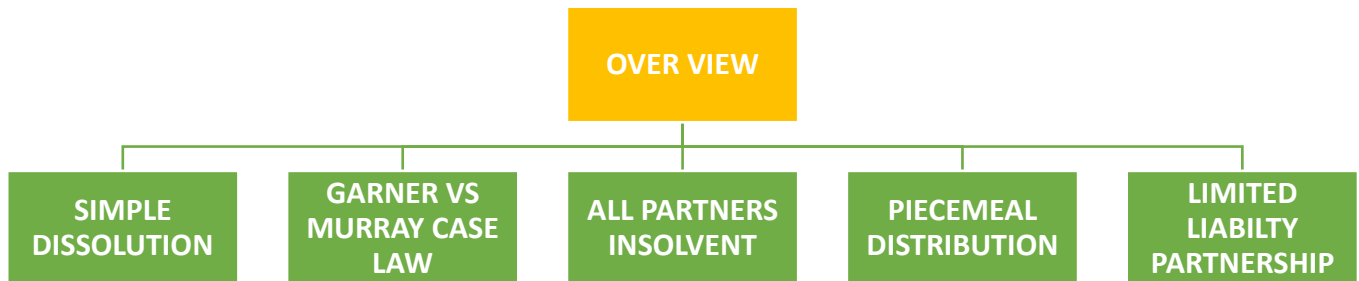
PROBLEM 2

Rohini Limited is in the business of manufacture of passenger cars and commercial vehicles. The Company is working on a strategic plan to close the production of passenger cars and to produce only commercial vehicles over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its prospective plan it will reduce the production of passenger cars by 20% annually. It also plans to establish another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner. You are required to comment:

1. If mere gradual phasing out in itself can be considered as a 'discontinuing operation' within the meaning of AS-24.
2. If the Company passes a resolution to sell some of the assets in the passenger car division and also to transfer few other assets of the passenger car division to the new factory, does this trigger the application of AS-24?
3. Would your answer to the above be different if the Company resolves to sell the assets of the passenger car division in a phased but time bound manner? **(JULY 2021 QP-1(b))**

7-PARTNERSHIP ACCOUNTS

(A)DISSOLUTION OF PARTNERSHIP FIRMS



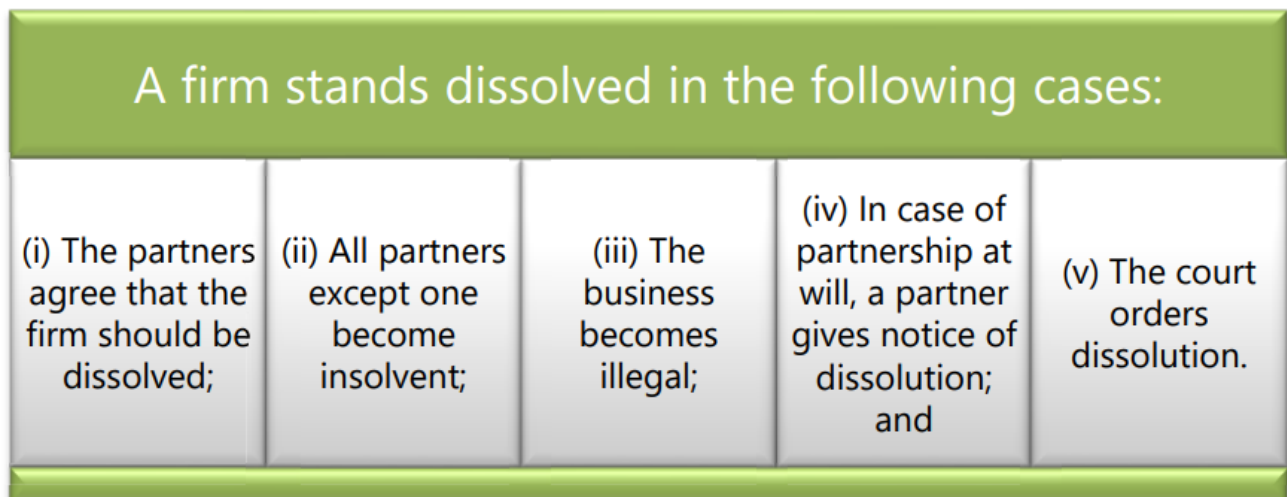
DISSOLUTION OF PARTNERSHIP:

In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted. There can be change in profit sharing ratio or admission/death/retirement of a partner.

DISSOLUTION OF PARTNERSHIP FIRM:

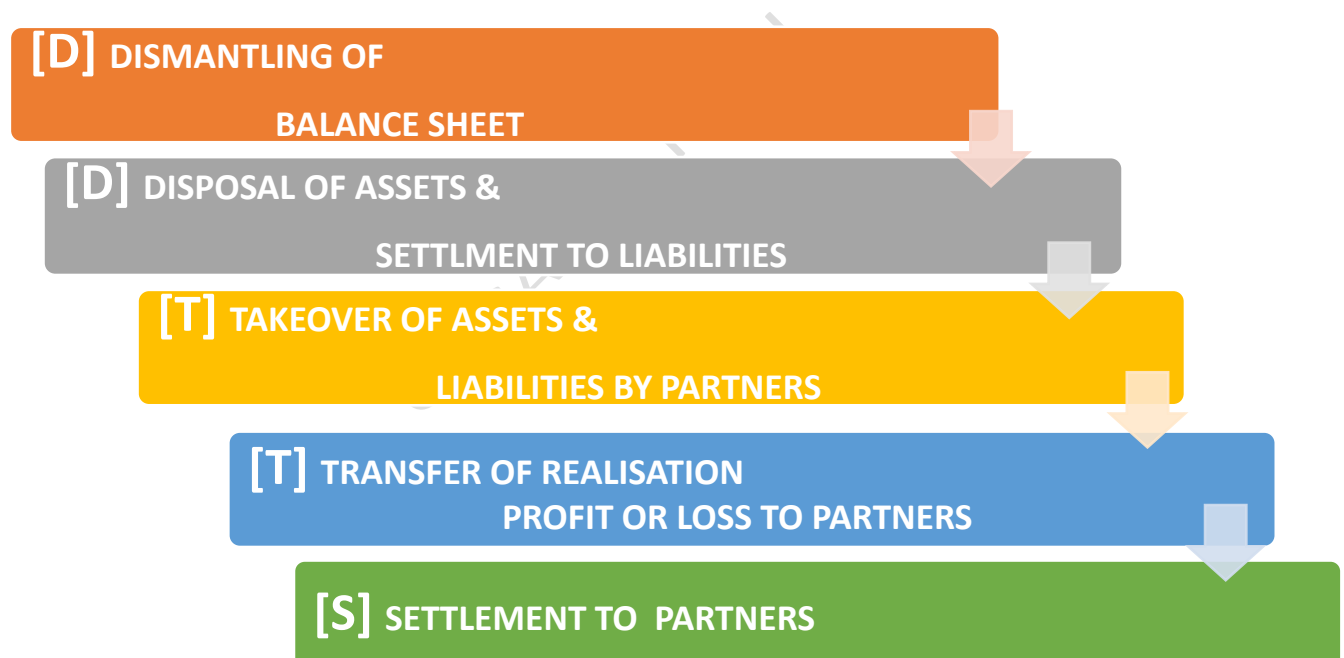
Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.

CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP:



The court has the option to order dissolution of a firm in the following circumstances :	(a)	Where a partner has become of unsound mind;
	(b)	Where a partner suffers from permanent incapacity;
	(c)	Where a partner is guilty of misconduct of the business;
	(d)	Where a partner persistently disregards the partnership agreement;
	(e)	Where a partner transfers his interest or share to a third party;
	(f)	Where the business cannot be carried on except at a loss; and
	(g)	Where it appears to be just and equitable.

ACCOUNTING TREATMENT IN CASE OF DISSOLUTION OF PARTNERSHIP FIRM-SIMPLE DISSOLUTION:



DISMANTLING OF BALANCE SHEET:

1. All assets (including goodwill) other than cash, fictitious assets and all outside Liabilities will be closed and transferred to Realisation A/c at their respective book values. Cash account, Partner's loan under Liability separately opened.

2. Partners capitals, Reserves and surplus including profit & loss balance, Fictitious assets, Partner's Loan under Assets will be closed and transferred to Partners Capital Account.

DISPOSAL OF ASSETS & SETTLEMENT TO LIABILITIES:

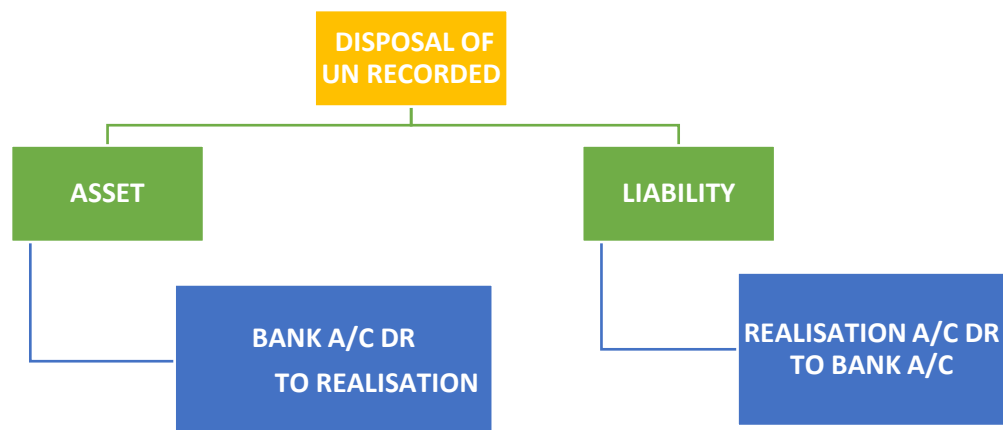
Practically Assets will be disposed in their order of solvency. As per section 48, Liabilities will be settled in the following order.

- Realisation expenses

- Liquidator remuneration
- Secured Liabilities
- Unsecured Liabilities
- Loans taken from partners
- Final payment to partner capitals

Journal entries:

1. <u>At the time of incurring Realisation expenses</u>			
Realisation a/c	Dr	XXXX	
To bank a/c			XXXX
2. <u>At the time of Disposal of Assets</u>			
Bank a/c	Dr	XXXX	
To Realisation a/c			XXXX
3. <u>At the time of Settlement to Liabilities</u>			
Realisation a/c	Dr	XXXX	
To bank a/c			XXXX



TAKEOVER OF ASSETS & LIABILITIES BY PARTNERS:

Journal entries:

1. <u>Takeover of Assets (recorded or unrecorded)</u>			
Partner capital a/c	Dr	XXXX	
To Realisation a/c			XXXX
2. <u>Takeover of Liabilities (recorded or unrecorded)</u>			
Realisation a/c	Dr	XXXX	

To Partner capital a/c		XXXX
------------------------	--	------

TRANSFER OF REALISATION PROFIT OR LOSS:

After completion of all dissolution activities before making payment to Partners capital, find Realisation Profit/Loss and make it transfer to Partners capital a/c.

FINAL SETTLEMENT TO PARTNERS:

Just distribute the cash balance available among Partners according to their outstanding capital balances.

GARNER VS MURRAY RULE

1. When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of insolvency loss is to be borne by other solvent partners following the decision in the English case of Garner vs. Murray.

2. PROVISIONS:

- A. Insolvency loss caused due to insolvent partner have to be borne by solvent partners who are having credit balance after all adjustments, in their capital ratio.
- B. Solvent partners having Dr or Cr balance should bring cash to that extent of Realisation loss in their profit-sharing ratio. (In actual practice they will not be bringing any cash; only a notional entry will be made.)

NOTES:

- 1. Garner vs Murray rule is applicable only if at least two solvent partners and one insolvent partner exist.
- 2. **Capital Ratio on Insolvency**

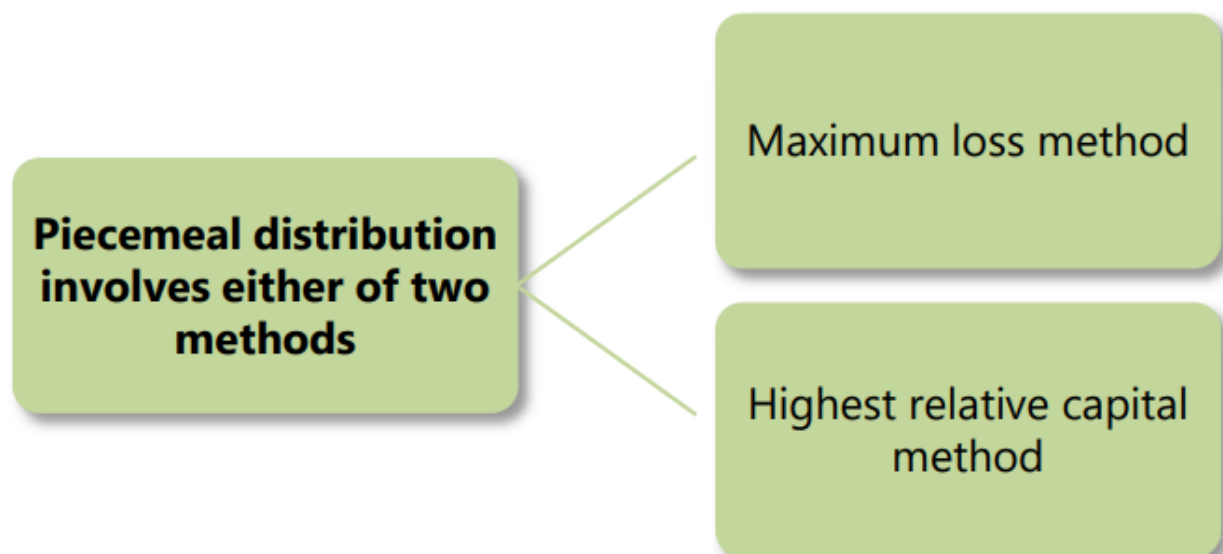
FIXED CAPITAL METHOD	FLUCTUATING CAPITAL METHOD
Fixed capitals given in Balance sheet will be base for calculation of capital ratio. Current accounts will be ignored.	Capital a/c balance as per Balance sheet XXXX + RESEVES & SURPLUS XXXX + INTEREST ON CAPITAL XXXX + PARTNER SALARY XXXX + PARTNER COMMISSION XXXX (-) DRAWINGS (XXXX) (-) INTEREST ON DRAWINGS (XXXX)

ALL PARTNERS INSOLVENT:

1. When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account. It will be opened separately.
2. Creditors may be paid the amount available including the amount contributed by the partners. The balance of the creditors' accounts is transferred to Deficiency Account.
3. The unsatisfied portion of the Capital Accounts of the partners will also transferred to Deficiency Account. Then all Accounts will be closed automatically.

PICEMAEAL DISTRIBUTION:

Generally, the assets sold upon dissolution of partnership are realized only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

**HIGHEST RELATIVE CAPITAL METHOD/PROPORINATE CAPITAL METHOD:**

According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off.

STEP1: Outstanding balance in Balance sheet will be taken as Base capital. [If any partner's Loan appearing under Assets side in balance sheet will be reduced from respective Partners capital]

STEP2: Profit sharing ratio

STEP3: Capital base per share= STEP1/STEP2

STEP4: Relative capital= Lowest capital base per share X Respective profit share

STEP5: Excess capital=STEP1-STEP4

After completion of all above steps, if there is balance at more than one partner and their balances not in Profit sharing ratio, the above steps will be repeated till the balance end up with one partner (or) balances will end at their mutual profit- sharing ratio.

MAXIMUM LOSS METHOD:

1. According to this method, each instalment realized is considered to be the final payment i.e., outstanding assets and claims are considered worthless.
2. At the time of distribution of possible loss, partners' accounts are adjusted on the basis of profit-sharing ratio rule.
3. Insolvency loss caused due to insolvent partners will be borne by Solvent partners in their capital ratio as per Garner vs Murray rule.

LIMITED LIABILITY PARTNERSHIP:

"Limited liability partnership" means a partnership formed and registered under Limited Liability Partnership Act, 2008.

NATURE OF LIMITED LIABILITY PARTNERSHIP:

1. A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.
2. A limited liability partnership should have perpetual succession.
3. Any change in the partners of a limited liability partnership should not affect the existence, rights, or liabilities of the limited liability partnership.
4. Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 should not apply to a limited liability partnership.
5. As per section 5 of the LLP Act, any individual or body corporate may be a partner in a limited liability partnership.
6. As per section 6 of the LLP Act, every limited liability partnership should have at least two partners.
7. As per Section 7 of the LLP Act, every limited liability partnership should have at least two designated partners who are individuals and at least one of them should be a resident in India.

LIABILITIES OF DESIGNATED PARTNER:

As per Section 8 of LLP Act, unless expressly provided otherwise in this Act, a designated partner should be-

(a) responsible for the doing of all acts, matters, and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement, and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and.

(b) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

Distinction between an ordinary partnership firm and an LLP:

	BASIS	LLP	PARTNERSHIP FIRM
1.	Regulating Act	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	Body corporate	It is a body corporate.	It is not a body corporate,
3.	Separate legal entity	It is a legal entity separate from its members.	It is a group of persons with no separate legal entity
4.	Creation	It is created by a legal process called registration under the LLP Act, 2008.	It is created by an agreement between the partners
5.	Registration	Registration is mandatory. LLP can sue and be sued in its own name.	Registration is voluntary. Only the registered partnership firm can sue the third parties.
6.	Perpetual succession	The death, insanity, retirement or insolvency of the partner(s) does not affect its existence of LLP. Members may join or leave but its existence continues forever.	The death, insanity, retirement or insolvency of the partner(s) may affect its existence. It has no perpetual succession.
7.	Liability	Liability of each partner limited to the extent to agreed contribution except in case of willful fraud	Liability of each partner is unlimited. It can be extended upto the personal assets of the partners.
8.	Mutual agency	Each partner can bind the LLP by his own acts but not the other partners.	Each partner can bind the firm as well as other partners by his own acts.
9.	Designated partners	At least two designated partners and at least one of them shall be resident in India.	There is no provision for such partners under the Partnership Act, 1932.
10	Number of Partners	Minimum 2 but no and maximum limit	Minimum 2 and maximum 50
11	Legal compliances	Only designated partners are responsible for all the compliances and penalties under this Act.	All partners are responsible for all the compliances and penalties under the Act.

Winding up and Dissolution

- Under section 63 of the LLP Act, 2008 an LLP may be wound up voluntarily or by the Tribunal and such LLP so wound up may be dissolved.
- Under section 64, LLP may be wound up by the Tribunal:
 - If the LLP decides that it should be wound up by the Tribunal;
 - If for a period of more than six months, the number of partners of the LLP is reduced below two;
 - If the LLP is unable to pay its debts;
 - If the LLP has acted against the interests of the integrity and sovereignty of India, the security of the state or public order;
 - If the LLP has defaulted in the filing of the Statement of Account and Solvency with the Registrar for five consecutive financial years;
 - If the Tribunal is of the opinion that it is just and equitable that the LLP be wound up.

PROBLEMS FOR DISCUSSION

PROBLEM NO 1:

X, Y and Z are partners of the firm XYZ and Co., sharing Profits and Losses in the ratio of 4 : 3 : 2.

Following is the Balance Sheet of the firm as at 31st March, 2012:

Balance Sheet as at 31st March, 2012

Liabilities	Rs.	Assets	Rs.
Partners' Capitals:		Fixed Assets	5,00,000
X	4,00,000	Stock in trade	3,00,000
Y	3,00,000	Sundry debtors	5,00,000
Z	2,00,000	Cash in hand	10,000
General Reserve	90,000		
Sundry Creditors	3,20,000		
	13,10,000		13,10,000

Partners of the firm decided to dissolve the firm on the above said date.

Fixed assets realized Rs. 5,20,000 and book debts Rs. 4,40,000.

Stocks were valued at Rs. 2,50,000 and it was taken over by partner Y.

Creditors allowed discount of 5% and the expenses of realization amounted to Rs. 6,000.

You are required to prepare:

1. Realisation account;
2. Partners capital account; and
3. Cash account.

(SM) (ANS.: (I) REALISATION LOSS X-35,555; Y-26,667; Z-17,778 (II) PARTNERS CAPITAL A/C TRANSFERRED CASH X-4,04,445; Y-53,333; Z-2,02,222. (III) CASH A/C TOTAL 9,70,000)

PROBLEM NO 2:

P, Q and R were partners sharing profits and losses in the ratio of 3 : 2 : 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 20X1 is as follows:

Liabilities	Amount	Assets	Amount
Fixed Capital		Fixed assets:	
P 20,000		Goodwill	40,000
Q 20,000		Freehold Property	8,000
R 10,000	50,000	Plant and Equipment	12,800
Current Accounts:		Motor Vehicle	700
P 500		Current Assets	
Q 9,000	9,500	Stock	3,900
Loan from P	8,000	Trade Debtors 2,000	
Trade Creditors	12,400	Less: Provision (100)	1,900
		Cash at Bank	200
		Miscellaneous losses	
		R's Current Account	400
		Profit and Loss Account	12,000
	79,900		79,900

On 1st July, 20X1 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of Rs. 500 but no cash passed specifically in respect of this transaction. Sale of other assets realised the following amounts:

Goodwill	Nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000

Trade Debtors	1,600
---------------	-------

Trade Creditors were paid Rs. 11,700 in full settlement of their debts. The costs of dissolution amounted to Rs. 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 of the amount due.

You are required to show:

- (a) Cash and Bank Account,
- (b) Realisation Account, and
- (c) Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

(SM) (ANS: CASH/ BANK A/C TOTAL-59,600, REALISATION A/C LOSS-51,000, PARTNER'S A/C TOTAL :P-45,500, Q-42,000, R-10,900)

PROBLEM NO 3:

A, B, C and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2012 when their balance sheet was as under:

Liabilities	Rs.	Assets	Rs.
Creditors	15,700	Bank	535
Employees Provident Fund	6,300	Debtors	15,850
Capital Accounts:		Stock	25,200
A 40,000		Prepaid Expenses	800
B <u>20,000</u>	60,000	Plant & Machinery	20,000
		Patents	8,000
		C's Capital A/c	3,200
		D's Capital A/c	8,415
	82,000		82,000

- a) One of the creditors took some of the patents whose book value was Rs.5,000 at a valuation of Rs.3,200. Balance of the creditors were paid at a discount of Rs.400.
- b) There was a joint life policy of Rs.20,000 (not mentioned in the balance sheet) and this was surrendered for Rs.4,500.
- c) **The remaining assets were realised at the following values:** Debtors Rs.10,800; Stock Rs.15,600; Plant and Machinery Rs.12,000; and Patents at 60% of their book-values. Expenses of realisation amounted Rs.1,500.

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firms claim against his estate. Prepare necessary ledger accounts.

(SM) (ANS.: LOSS ON REALISATION IS 23,050, TOTAL OF BANK A/C IS 71,860)

PROBLEM NO4:

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 20X1 when the firm was dissolved:

Liabilities	₹	Assets	₹
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1,000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		5,550

The assets realized as under:

Particulars	₹
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realization amounted to ` 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of ` 200 only. Show necessary ledger accounts to close the books of the firm.

PROBLEM NO 5:

Yash, Tanish and Ruchika were partners sharing profit & loss in ratio 3:2:1. Balance sheet of the firm is as follows:

Liabilities	Amounts Rs.	Assets	Amounts Rs.
Fixed capital:		Fixed Assets	45,000
-Yash	50,000		

-Tanish	20,000		
-Ruchika	10,000		
Cash accounts:		Investments	15,000
-Yash	6,000		
-Ruchika	4,000		
Unsecured Loans	15,000	Current Assets:	
		-stock	10,000
		-debtors	27,500
		-cash & bank	12,500
Current Liabilities	15,000	Current account:	
		-Tanish	10,000
	1,20,000		1,20,000

On 1st April, 20X1 all the partners agreed to form a new company YTR Pvt. Ltd. Which will take over the firm as going concern including goodwill, but excluding cash and bank balances. The following matters were also agreed upon:

- Goodwill should be valued at 3 years purchase of super profits
- Actual profit for the purpose of goodwill valuation will be Rs.20,000
- The normal rate of return will be 17.50% per annum of Fixed capital.
- All other assets and liabilities will be taken over at book value.
- The purchase consideration will be paid partly in share of Rs. 1 each and partly in cash. Yash and Tanish to acquire interest in new company in the ratio of 3:2 at face value. Ruchika agreed to retire after taking her share in cash.
- Realisation expenses amounted to Rs.5000.

Prepare Realisation Account, cash and bank Account, YTR Private Limited account and Capital Accounts of the partners.

PROBLEM NO 6:

Ajay Enterprises, a Partnership firm in which A, B and C are three partners sharing profits and losses in the ratio of 4 : 3 : 3. The balance sheet of the firm as on 31st December, 2011 is as below:

Liabilities	Rs.	Assets	Rs.
A' s Capital	15,000	Factory Building	24,160
B' s Capital	7,500	Plant & Machinery	16,275

C' s Capital	15,000	Debtors	5,400
B' s Loan	4,500	Stock	12,390
Sundry Creditors	16,500	Cash at Bank	275
	58,500		58,500

On balance sheet date all the three partners have decided to dissolve their partnership. Since the realization of assets was protracted, they decided to distribute amounts as and when feasible and for this purpose they appoint C who was to get as his remunerations 1% of the value of the assets realized other than cash at Bank and 10% of the amount distributed to the partners.

Assets were realized piecemeal as under:

Rs.

First instalment	18,650
Second instalment	17,320
Third instalment	10,000
Last instalment	7,000
Dissolution expenses were provided for estimated amount of	3,000
The creditors were settled finally for	15,900

Prepare a statement showing distribution of cash amongst the partners by 'Higher Relative Capital Method'.

(SM)(ANS: LOSS SUFFERED BY PARTNERS A: 4,340, B: 3,255, C: 3,255)

PROBLEM NO 7:

The partners A, B, and C have called you to assist them in winding up the affairs of their partnership on 30th June, 20X1. Their Balance Sheet as on that date is given below:

Liabilities	AMOUNT RS.	Assets	AMOUNT RS.
Sundry Creditors	17,000	Cash at Bank	6,000
Capital Accounts:		Sundry Debtors	22,000
A	67,000	Stock in trade	14,000
B	45,000	Plant and Equipment	99,000
C	31,500	Loan-A	12,000
		Loan-B	7,500

	1,60,500		1,60,500
--	----------	--	----------

- (1) The partners share profit and losses in the ratio of 5:3:2
- (2) Cash is distributed to the partners at the end of each month
- (3) A summary of liquidation transactions are as follows:

July 20X1`

16,500 – collected from Debtors; balance is uncollectable.

10,000 – received from the sale of entire stock.

1,000 – liquidation expenses paid.

8,000 – cash retained in the business at the end of the month.

August 20X1`

1,500 – liquidation expenses paid. As part payment of his Capital, C accepted a piece of equipment for ` 10,000 (book value 4,000).

2,500 – cash retained in the business at the end of the month.

September 20X1`

75,000 – received on sale of remaining plant and equipment.

1,000 – liquidation expenses paid. No cash retained in the business.

Required: Prepare a schedule of cash payments as of September 30, showing how the cash was distributed under 'Highest Relative Capital Method'.

(SM-PRACTICAL QUESTION 5)

PROBLEM NO 8:

The following is the Balance Sheet of A, B, C on 31st December, 20X1 when they decided to dissolve the partnership:

LIABILITIES	RS	ASSETS	RS
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		

C	9,000		
	49,000		49,000

The assets realized the following sums in instalments:

I	1,000
II	3,000
III	3,900
IV	6,000
V	<u>20,100</u> (Includes saving in expenses)
	34,100

The expenses of realization were expected to be `500 but ultimately amounted to ` 400 only. Show how at each stage the cash received should be distributed between partners by applying maximum possible loss Method. They share profits in the ratio of 2:2:1 **(PROBLEM 7-SM)**

TEST YOUR KNOWLEDGE

MCQ

1. Partnership could be dissolved because of

- (a) Death of a partner.
- (b) Insolvency of a partner.
- (c) Either (a) or (b).

2. On the dissolution of partnership, profit or loss on realization of assets and liabilities should be divided among partners

- (a) In the ratio of their capitals.
- (b) In the same ratio in which they share profits.
- (c) Equally.

3. An unrecorded asset realized at the time of dissolution is credited to

- (a) Realization account.
- (b) Revaluation account.
- (c) Capital accounts.

4. A liability taken over by a partner at the time of dissolution is credited to

- (a) Profit and loss account.
- (b) Partners' capital accounts.
- (c) Realization account.

5. Realization account is a

- (a) Nominal account.
- (b) Real account.
- (c) Personal account.

6. Which of the following method/methods is adopted to ensure that distribution of cash among partners is in proportion to their interest in partnership?

- (a) Maximum loss method.
- (b) Highest relative capital method.
- (c) Either (a) or (b).

Theoretical Questions

Question 1

State the circumstances when Garner V/S Murray rule not applicable.

Answer 1

Non-Applicability of Garner vs Murray rule:

1. When the solvent partner has a debit balance in the capital account. Only solvent partners will bear the loss of capital deficiency of insolvent partner in their capital ratio. If incidentally, a solvent partner

has a debit balance in his capital account, he will escape the liability to bear the loss due to insolvency of another partner. 2. When the firm has only two partners.

3. When there is an agreement between the partners to share the deficiency in capital account of the insolvent partner.

4. When all the partners of the firm are insolvent.

Question 2

W paid a premium to other partners of the firm at the time of his admission to the firm, with a condition that they will not be dissolved before the expiry of five years. The firm is dissolved after three years. W claims refund of premium.

- (i) List the criteria for the calculation of the amount of refund.
- (ii) Also list any two conditions when no claim in this respect will arise.

Answer 2

If the firm is dissolved before the term expires, as is the case, W being a partner who has paid a premium on admission will have to be repaid/refunded

The criteria for calculation of refund amount are:

- (i) Terms upon which admission was made,
- (ii) The time period for which it was agreed that the firm will not be dissolved,
- (iii) The time period for which the firm has already been in existence.

No claim for refund will arise if:

- (i) The firm is dissolved due to the death of a partner,
- (ii) If the dissolution of the firm is basically because of misconduct of W,
- (iii) If the dissolution is through an agreement and such an agreement does not have a stipulation for a refund of premium.

Question 3

Can a partner be called upon to pay the liability of the LLP? If yes, under what circumstances?

Answer 3

Under the LLP Act, 2008, any obligation of the LLP arising out of a contract or otherwise will be the sole obligation of the LLP. The partners of an LLP in the normal course of business are not liable for the debts of the LLP. However, a partner will be liable for his own wrongful acts or commissions, but will not be liable for the wrongful acts or commissions of other partners of the LLP.

Question 4

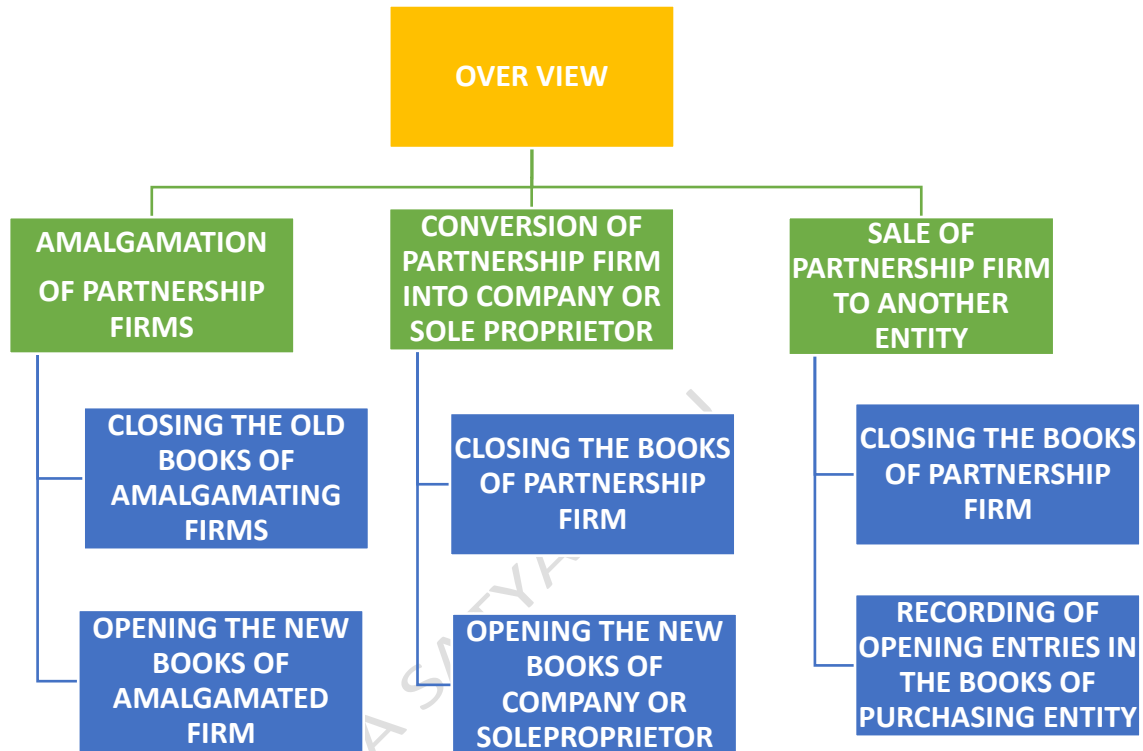
Under what circumstances, an LLP can be wound up by the Tribunal.

Answer 4

Under the following circumstances, an LLP can be wound up by the Tribunal:

- (i) If the LLP decides that it should be wound up by the Tribunal;
- (ii) If for a period of more than six months, the number of partners of the LLP is reduced below two;
- (iii) If the LLP is unable to pay its debts;
- (iv) If the LLP has acted against the interests of the integrity and sovereignty of India, the security of the state or public order;
- (v) If the LLP has defaulted in the filing of the Statement of Account and Solvency with the Registrar for five consecutive financial years;
- (vi) If the Tribunal is of the opinion that it is just and equitable that the LLP be wound up.

(B)AMALGAMTION, CONVERSION AND SALE OF PARTNERSHIP FIRMS



ACCOUNTING TREATMENT IN THE BOOKS OF SELLING FIRM:

FIVE STEP APPROACH:

STEP1: DISMANTLING OF BALANCE SHEET

- a. All Assets and Liabilities which are taken over by purchasing entity will be closed and transferred to Realization a/c at book values.
- b. If any particular Asset or Liability which is not taken over by purchasing entity, opened separately for the purpose of realization in outside market.
- c. Partner's capital appearing in Balance sheet, Reserves & Surplus, Fictious Assets transferred to Partner's capital a/c.

STEP 2: PURCHASE CONSIDERATION DUE

- (i) Calculate Purchase consideration by providing separate working note.
- (ii) With the amount of Purchase consideration Debit the Purchasing entity a/c and Credit the Realization a/c.

STEP3: PURCHASE CONSIDERATION RECEIVED

Purchasing entity A/c will be closed by debiting the purchase consideration in the form of share in new Partnership firm, Equity shares of Purchasing co., Preference shares of purchasing co., Debentures of purchasing co., Cash etc.as the case applicable.

STEP4: DISTRIBUTION OF PURCHASE CONSIDERATION

1. Dispose those assets which are not taken over by the purchasing company in out side market and any profit or loss derived transferred to Realization a/c.
2. With the available cash and P.c received by the selling firm will be distributed among various parties in particular order decided by Liquidation provisions.
 - (i) Realization expenses/Liquidation expenses
 - (ii) Secured creditors
 - (iii) Un secured creditors
 - (iv) Finally among Partners

During this process of distribution any profit or loss derived will be transferred to Realization a/c.

STEP5: FINAL SETTLEMENT TO PARTNERS

1. Before making settlement to Partners, close Realization a/c and find Realization profit or loss. Such profit or loss will be transferred to Partner's capital a/c.
2. All the remaining Resources in selling firm just distribute among Partners. All accounts in dissolving firm will be closed with this final step.

ACCOUNTING TREATMENT IN THE BOOKS OF PURCHASING ENTITY:

1. The assets and liabilities of the transferor firm should be incorporated at their agreed values.
2. Any excess of the amount of purchase consideration over the value of the net assets of the transferor firm acquired by the transferee entity should be recognized as goodwill in the financial statement of the transferee entity. Any short fall should be shown as capital reserve.

IMPORTANT POINTS:

1. In case of Amalgamation of partnership firms, If purchasing entity don't want to open goodwill account in their books then adjustment will happen through partner capital accounts.
2. When the partnership firm is converted into a company, then the financial statements of the new company will be prepared according to Schedule III to the Companies Act, 2013.
3. After acquisition if purchasing entity continue same set of books then acquisition entries are nothing but elimination of Assets and liabilities by debiting Business purchase a/c.

PROBLEMS FOR DISCUSSION

PROBLEM NO 9:

B and S are partners of S & Co. sharing profits and losses in the ratio of 3:1. S and T are partners of T & Co. sharing profits and losses in the ratio of 2:1. On 31st October, 2011, they decided to amalgamate and form a new firm M/s. BST & Co. wherein B, S and T would be partners sharing profits and losses in the ratio of 3:2:1. Their balance sheets on that date were as under:

Liabilities	S & Co.	T & Co.	Assets	S & Co	T & Co
Due to X & Co	40,000	–	Cash in hand	10,000	5,000
Due to S & Co	–	50,000	Cash at bank	15,000	20,000
Other:			Due from T & Co	50,000	–
Creditors	60,000	58,000	Due from X & Co	–	30,000
Reserves	25,000	50,000	Other Debtors	80,000	1,00,000
Capitals:			Stock	60,000	70,000
B	1,20,000	---	Furniture	10,000	3,000
S	80,000	1,00,000	Vehicles	–	80,000
T	----	50,000	Machinery	75,000	–
			Building	25,000	–
	3,25,000	3,08,000		3,25,000	3,08,000

The amalgamated firm took over the business on the following terms:

1. Goodwill of S & Co. was worth Rs.60,000 and that of T & Co. Rs.50,000. Goodwill account was not to be opened in the books of the new firm, the adjustments being recorded through capital accounts of the partners.
2. Building, machinery and vehicles were taken over at Rs.50,000, Rs.90,000 and Rs.1,00,000 respectively
3. Provision for doubtful debts has to be carried forward at Rs.4,000 in respect of debtors of S & Co. and Rs.5,000 in respect of debtors of T & Co.

You are required to:

1. Compute the adjustments necessary for goodwill.
2. Pass the journal entries in the books of BST & Co. assuming that excess/deficit capital (taking T's Capital as base) with reference to share in profits are to be transferred to current accounts.

PROBLEM NO 10:

Hari, Lal and Jay have been in partnership for a number of years, sharing profits/losses in the ratio of 2:2:1 as wholesale stationers trading under the name 'Hari Brothers'. They decide to convert their partnership into a limited company (with effect from 1st January, 2013) to be known as Hari Ltd.

Immediately prior to this conversion the balance sheet of partnership as at 31st December 2012 was as follows:

Balance Sheet As on 31st December 2012

Liabilities	Rs.	Rs.	Assets	Rs.
Capital accounts:			Fixed assets: (at written down value)	
Hari	70,000		Land & Buildings	50,000
Lal	30,000		Plant & Machinery	30,000
Jay	<u>20,000</u>	1,20,000	Motor vehicles	20,000
Current accounts:			Current Assets:	
Hari	7,000		Inventories	60,000
Lal	5,000		Debtors	25,000
Jay	<u>3,000</u>	15,000	Axis Bank account	5,000
Current liabilities:				
Creditors	25,000			
Dena Bank account	<u>20,000</u>	45,000		
Long-term liabilities:				
Loan-Hari	3,000			
Loan-Gopi Ltd.	<u>7,000</u>	10,000		
		1,90,000		1,90,000

The terms of conversion are that Hari Ltd. is to take over the assets and liabilities of Hari Brothers as follows:

	Valuation for take-over Rs.
Land and Building	96,000

Plant and Machinery	28,000
Inventories	60,000
Debtors	24,000
Creditors	25,000
Goodwill	10,000

The closing balance in Axis Bank account is to be transferred to Dena Bank account before all the other dissolution entries are effected in the partnership ledgers.

Lal took over one of the motor vehicles at an agreed amount of Rs. 2,000. Remaining motor vehicles taken over by Hari Ltd for Rs.15,000. All other liabilities were paid from the Dena Bank account.

The purchase consideration is discharged by an issue at par of Rs. 60,000 10% Debentures (fully paid) to the partners in their capital account proportions as shown in the above balance sheet plus equity shares in Hari Ltd. of Rs. 1 each (fully paid to make up the balance due to each partner).

You are required to

1. Prepare (a) Realisation Account (b) Partners' Capital Accounts (c) Bank account of Axis Bank and Dena Bank in the books of Hari Brothers;
2. 'Business purchase account' and 'Hari Brothers' account in Hari Ltd.'s books.

(SM) (ANS: (I) (A) PROFIT ON REALISATION A/C HARI-20,000,LAL-20,000,JAY-10,000 (B) TOTAL OF PARTNER'S CAPITAL A/C HARI-97,000,LAL-55,000,JAY-33,000, (C) TOTAL OF BANK A/C AXIS BANK-5,000, DENA BANK-30,000 (II) TOTAL OF BUSINESS PURCHASE A/C-2,33,000, TOTAL OF HARI BROTHERS A/C-1,83,000)

PROBLEM NO 11:

A and B were carrying on business sharing profits and losses equally. The firm's Balance Sheet as at 31.12.2011 was:

Liabilities	Amount	Assets	Amount
Sundry Creditors	60,000	Stock	60,000
Bank overdraft	35,000	Machinery	1,50,000
Capital A/c's:		Debtors	70,000
A 1,40,000		Joint Life Policy	9,000
B <u>1,30,000</u>	2,70,000	Leasehold Premises	34,000
		Profit & Loss A/c	26,000

		Drawings Accounts:	
		A 10,000	
		B <u>6,000</u>	16,000
	3,65,000		3,65,000

The business was carried on till 30.6.2012. The partners withdrew in equal amounts half the amount of profits made during the period of six months after charging depreciation at 10% p.a. on machinery and after writing off 5% on leasehold premises. In the half year, sundry creditors were reduced by Rs.10,000 and bank overdraft by Rs.15,000.

On 30.6.2012, stock was valued at Rs.75,000 and Debtors at Rs.60,000; the Joint Life Policy had been surrendered for Rs.9,000 before 30.6.2012 and other items remained the same as at 31.12.2011.

On 30.6.2012, the firm sold the business to a Limited Company. The value of goodwill was fixed at Rs.1,00,000 and the rest of the assets were valued on the basis of the Balance Sheet as at 30.06.2012. The company paid the purchase consideration in Equity Shares of Rs.10 each.

You are required to prepare: (a) Balance Sheet of the firm as at 30.06.2012; (b) The Realisation Account; (c) Partners' Capital Accounts showing the final settlement between them.

(SM) (ANS.: TOTAL OF BALANCE SHEET IS 3,09,800, TOTAL OF REALISATION A/C IS 4,09,800)

PROBLEM NO 12:

A, B and C were in partnership sharing profits and losses 3:2:1. There was no provision in the agreement for interest on capitals or drawings.

A died on 01.01.2011 and on that date, the partners' balance was as under:

Capital Account: A - Rs.60,000; B- Rs.40,000; C - Rs.20,000

Current Account: A - Rs.29,000; B - Rs.20,000; C - Rs.5,000 (Dr.).

By the partnership agreement, the sum due to A's estate was required to be paid within a period of 3 years, and minimum installment of Rs.20,000 each were to be paid, the first such installment falling due immediately after death and the subsequent installments at half-yearly intervals. Interest @ 5% p.a. was to be credited half-yearly.

In ascertaining his share, goodwill (not recorded in the books) was to be valued at Rs.60,000 and the assets, excluding the Joint Endowment Policy (mentioned below), were valued at Rs.36,000 in excess of the book values.

No Goodwill Account was raised, and no alteration was made to the book values of fixed assets. The Joint Assurance Policy shown in the books at Rs.20,000 matured on 1.1.2011, realizing Rs.26,000; payments of Rs.20,000 each were made to A's Executors on 1.1.2011, 30.6.2011 and 31.12.2011. B and C continued trading on the same terms as previously and the net profit for the year to 31.12.2011 (before charging the interest due to A's estate) amounted to Rs.32,000. During that period, the partner's drawings were: B- Rs.15,000; and C- Rs.8,000.

On 1.1.2012, the partnership was dissolved and an offer to purchase the business as a going concern for Rs.1,40,000 was accepted on that day. A cheque for that sum was received on 30.6.2012. The balance due to A's estate, including interest, was paid on 30.6.2012 and on that day, B and C received the sums due to them.

You are required to write-up the Partners' Capital and Current Accounts from 01.01.2011 to 30.06.2012. Show also the account of the executors of A.

(SM) (ANS.: BALANCE OF CURRENT A/C TRANSFERRED TO CAPITAL A/C OF B: 5,190, C: (12,905) AND BALANCE OF PARTNER'S CAPITAL A/C: B: 45,190; C: 7,095; AMOUNT PAID TO A'S EXECUTORS ON 30.06.2012: 87,715)

PROBLEM NO 13:

Prabhu & Co. is a partnership firm consisting of Mr. Prabhu, Mr. Bhola and Mr. Shiv who share profits and losses in the ratio of 2:2:1

and Bhagwan Ltd. is a company doing similar business. Following is the Balance sheet of the firm and that of the company as at 31.3.2012:

Liabilities	Prabhu & Co.	Bhagwan Ltd.	Assets	Prabhu & Co.	Bhagwan Ltd.
Equity share Capital:			Plant & machinery	2,50,000	8,00,000
Equity shares of Rs.10 each		10,00,000	Furniture & fixture	25,000	1,12,500
Partners' capital:			Stock in trade	1,00,000	4,25,000
Prabhu	1,00,000		Sundry debtors	1,00,000	4,12,500
Bhola	1,50,000		Cash at bank	5,000	2,00,000
Shiv	50,000		Cash in hand	20,000	50,000
General reserve	50,000	3,50,000			

Sundry creditors	1,50,000	6,50,000			
	5,00,000	20,00,000		5,00,000	20,00,000

It was decided that the firm Prabhu & Co. be dissolved and all the assets (except cash in hand and cash at bank) and all the liabilities of the firm be taken over by Bhagwan Ltd. by issuing 25,000 shares of Rs 10 each at a premium of Rs. 2 per share.

Partners of Prabhu & Co. agreed to divide the shares issued by Bhagwan Ltd. in the profit-sharing ratio and bring necessary cash for settlement of their capital.

The creditors of Prabhu & Co. includes Rs. 50,000 payables to Bhagwan Ltd. An unrecorded liability of Rs 12,500 of Prabhu & Co. must also be taken over by Bhagwan Ltd.

Prepare:

- i) Realisation account, Partners' capital accounts and Cash in hand/Bank account in the books of Prabhu & Co.
- ii) Pass journal entries in the books of Bhagwan Ltd. for acquisition of Prabhu & Co.

(SM) (ANS.: (A) LOSS ON REALISATION: RS. 25,000)

PROBLEM NO 14:

Sagar & Sons is a partnership firm consisting of Mr. X, Mr. Y, and Mr. Z who share profits and losses in the ratio of 2:2:1, and UTS Ltd. is a company doing similar business.

The firm (Sagar & Sons) and the company (UTS Ltd.) provide you the following Ledger Balances as on 31.3.20X1:

On the Balance Sheet date, it was decided that the firm M/s Sagar & Sons be dissolved and all the assets (except cash in hand and cash at bank) and all the liabilities of the firm be taken over by UTS Ltd. by issuing 50,000 shares of ` 10 each at a premium of ` 2 per share.

Partners of Sagar & Sons agreed to divide the shares issued by UTS Ltd. in the profit-sharing ratio and bring necessary cash for settlement of their capital.

The trade payables of Sagar & Sons includes ` 1,00,000 payable to UTS Ltd. An unrecorded liability of ` 25,000 of Sagar & Sons must also be taken over by UTS Ltd.

Prepare:

- (1) Realisation account, Partners' capital accounts, and Cash in hand/Bank account in the books of Sagar & Sons.

(2) Pass journal entries in the books of UTS Ltd. for acquisition of Sagar & Sons and draw the Balance Sheet of UTS Ltd. after the takeover. **(SM PRACTICAL QUESTION 5)**

TEST YOUR KNOWLEDGE

MCQ

1. Amalgamation of partnership firms includes
 - (a) Closing the old books of Amalgamating firms.
 - (b) Opening the new books of Amalgamated firm.
 - (c) Both (a) and (b).

2. When one firm is merged with another existing firm, entries will be made for
 - (a) Winding up in the books of firm which will cease to exist.
 - (b) Business purchase in the books of another firm.
 - (c) Both (a) and (b).

3. In case of amalgamation of firms, profit/ loss on the sale of the firm is ascertained by
 - (a) Realization account.
 - (b) Revaluation account.
 - (c) New firm's account.

4. Liabilities not taken over by the new firm (at the time of amalgamation) will be transferred to
 - (a) Capital accounts
 - (b) Revaluation account.
 - (c) New firm's account.

5. While closing the books of the old firm, assets and liabilities not taken over by the new firm should be transferred to
 - (a) Revaluation account.
 - (b) Partners' capital accounts.
 - (c) Realization account.

8. CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED FINANCIAL STATEMENTS:

CFS are the financial statements of a 'group' presented as those of a single enterprise, where a 'group' refers to a parent and all its subsidiaries. Here Subsidiary includes Associate and Joint venture.

PURPOSE OF PREPARING CFS:

Parent company needs to inform the users about the financial position and results of operations of not only of their enterprise itself but also of the group as a whole. For this purpose, consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity.

HOLDING COMPANY:

As per Section 2(46) of the Companies Act, 2013, "Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

SUBSIDIARY COMPANY:

Section 2(87) of the Companies Act, 2013 defines "subsidiary company" as 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.

MINORITY INTREST

It 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.

RELEVANT PROVISIONS OF COMPANIES ACT 2013:

1. Where a company has one or more subsidiaries or associate companies, it shall, in addition to the standalone financial statements, prepare a consolidated financial statement of the company and of all the subsidiaries, associate companies and joint ventures in the same form and manner as that of its own and in accordance with applicable accounting standards, which shall also be laid before the annual general meeting (AGM) of the company along with the laying of its financial statement.
2. 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 Form AOC-1 as per Rule 5 of the Companies (Accounts) Rules, 2014.

3. The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Companies Act 2013 and the applicable accounting standards.

4. Exemptions from preparation of CFS:

As per Companies (Accounts) Amendment Rules, 2016, preparation of consolidated financial statements by a company is not required if it meets the following conditions:

- (i) it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;
- (ii) it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in or outside India; and
- (iii) its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

AS 21 CONSOLIDATED FINANCIAL STATEMENTS

- 1. AS 21 prescribes accounting principles and procedures for preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.
- 2. AS 21 is mandatory if an enterprise presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21.

EXCLUSION FROM PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS:

As per AS 21, 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.
1. In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with AS 13 'Accounting for Investments'. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

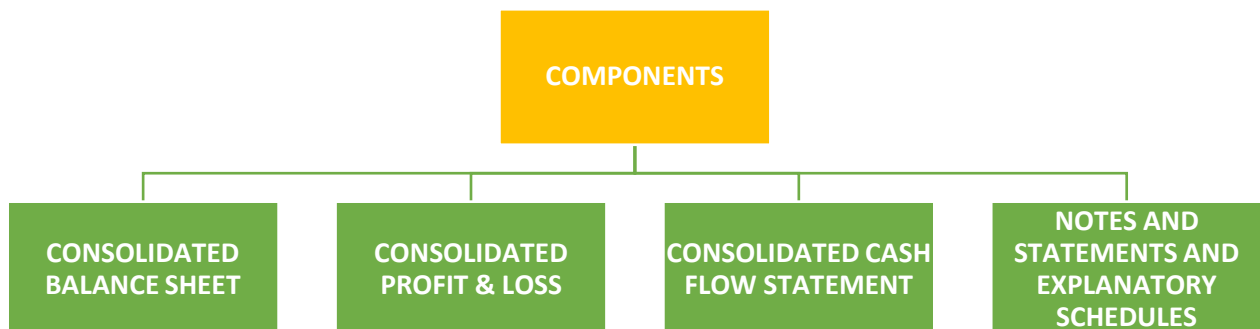
2. Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise is considered to be temporary.

ADVANTAGES OF CONSOLIDATED FINANCIAL STATEMENTS:

The main advantages of consolidation are given below:

- (i) **Single source document:** From the consolidated financial statements, the users of accounts can get an overall picture of the Group (i.e. holding company and its subsidiaries). Consolidated profit and loss account gives the overall profitability of the group.
- (ii) **Intrinsic value of share:** Intrinsic share value of the holding company can be calculated directly from the Consolidated Balance Sheet.
- (iii) **Acquisition of subsidiary:** The minority interest data of the consolidated financial statement indicates that the amount payable to the outside shareholders of the subsidiary company at book value which is used as the starting point of bargaining at the time of acquisition of a subsidiary by the holding company.
- (iv) **Evaluation of holding company in the market:** The overall financial health of the holding company can be judged using consolidated financial statements. Those who want to invest in the shares of the holding company or acquire it, need such consolidated statement for evaluation.

COMPONENTS OF CONSOLIDATED FINANCIAL STATEMENTS:

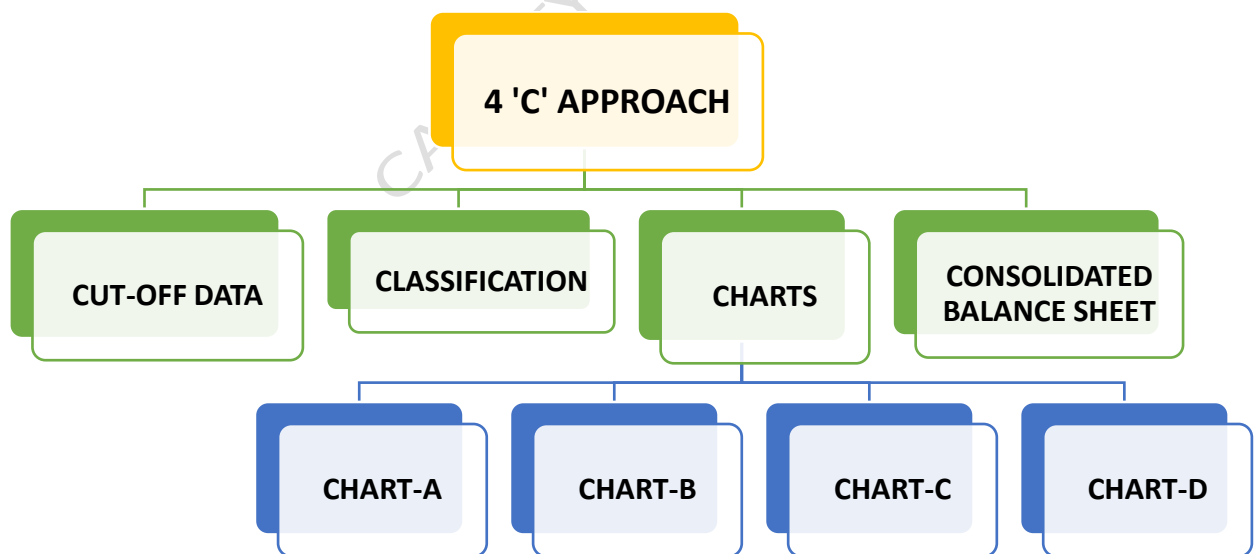


CONSOLIDATION PROCEDURES:

Rule 6 of the Companies (Accounts) Rules, 2014 states that the manner of consolidation of financial statements of the company shall be in accordance with the provisions of Schedule III of the Act and the applicable accounting standards. AS 21, lays down the procedure for consolidation of financial statements of the companies within the group.

CONSOLIDATED BALANCE SHEET

1. While preparing the consolidated balance sheet, assets and liabilities of the subsidiary company are merged with those of the holding company.
2. Share capital and reserves and surplus of subsidiary company are apportioned between holding company and minority shareholders. These items, along with investments of holding company in shares of subsidiary company are not separately shown in consolidated balance sheet.
3. The net amounts resulting from various computations on these items, shown as
 - (a) minority interest
 - (b) cost of control
 - (c) holding company's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the holding company) are entered in consolidated balance sheet.

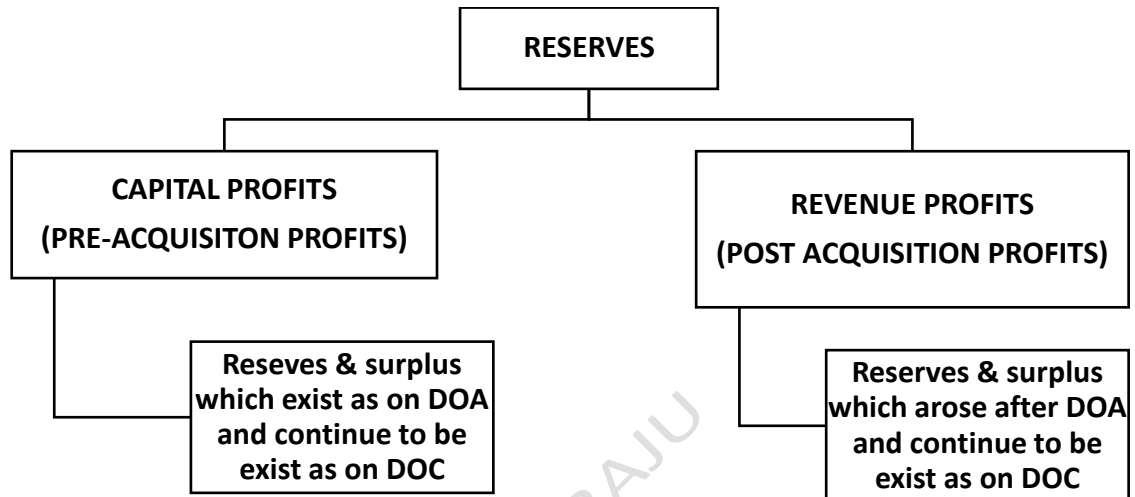


1. CUT-OFF DATA:

PARTICULARS	
Percentage of Holding interest	XXXX
Percentage of Minority interest	XXXX
Date of acquisition	XXXX
Date of consolidation	XXXX

2. CLASSIFICATION:

The Reserves & surplus of subsidiary will be divided into two parts. Each component of Reserves & surplus will be separately segregated.



3. CHARTS:

CHART A: COMPUTATION OF MINORITY INTREST

PARTICULARS	TOTAL	HI	MI
Equity share capital in subsidiary co.	XXXX	XXXX	XXXX
<u>ADD: CAPITAL PROFITS</u>			
P&L	XXXX	XXXX	XXXX
General reserve	XXXX	XXXX	XXXX
Statutory reserve	XXXX	XXXX	XXXX
USEFUL FOR CALCULATION OF COST OF CONTROL IN CHART B		XXXX	
<u>ADD: REVENUE PROFITS</u>			
P&L	XXXX	XXXX	XXXX
General reserve	XXXX	XXXX	XXXX
Statutory reserve	XXXX	XXXX	XXXX
MINORITY INTREST			XXXX

NOTES:

- Minority interest represents the claims of the outside shareholders of a subsidiary.
- Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. I.e it is presented after Share holder fund as separate line item in CBS.

- iii) 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 profit, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

CHARTB: CALCULATION OF COST OF CONTROL

PARTICULARS	AMOUNT
Cost of investment $\longrightarrow$ A	XXXX
LESS: Parent's share in the equity of the subsidiary on date of investment $\longrightarrow$ B	XXXX
COST OF CONTROL = A>B - GOODWILL (OR) A<B - CAPITAL RESERVE	XXXX

CHARTC: MUTUAL OWINGS

PARTICULARS	ASSET	LIABILITY
Holding company	XXXX	XXXX
Subsidiary company	XXXX	XXXX
Total	XXXX	XXXX
Less: Mutual owings	XXXX	XXXX
Net balance shown under CBS	XXXX	XXXX

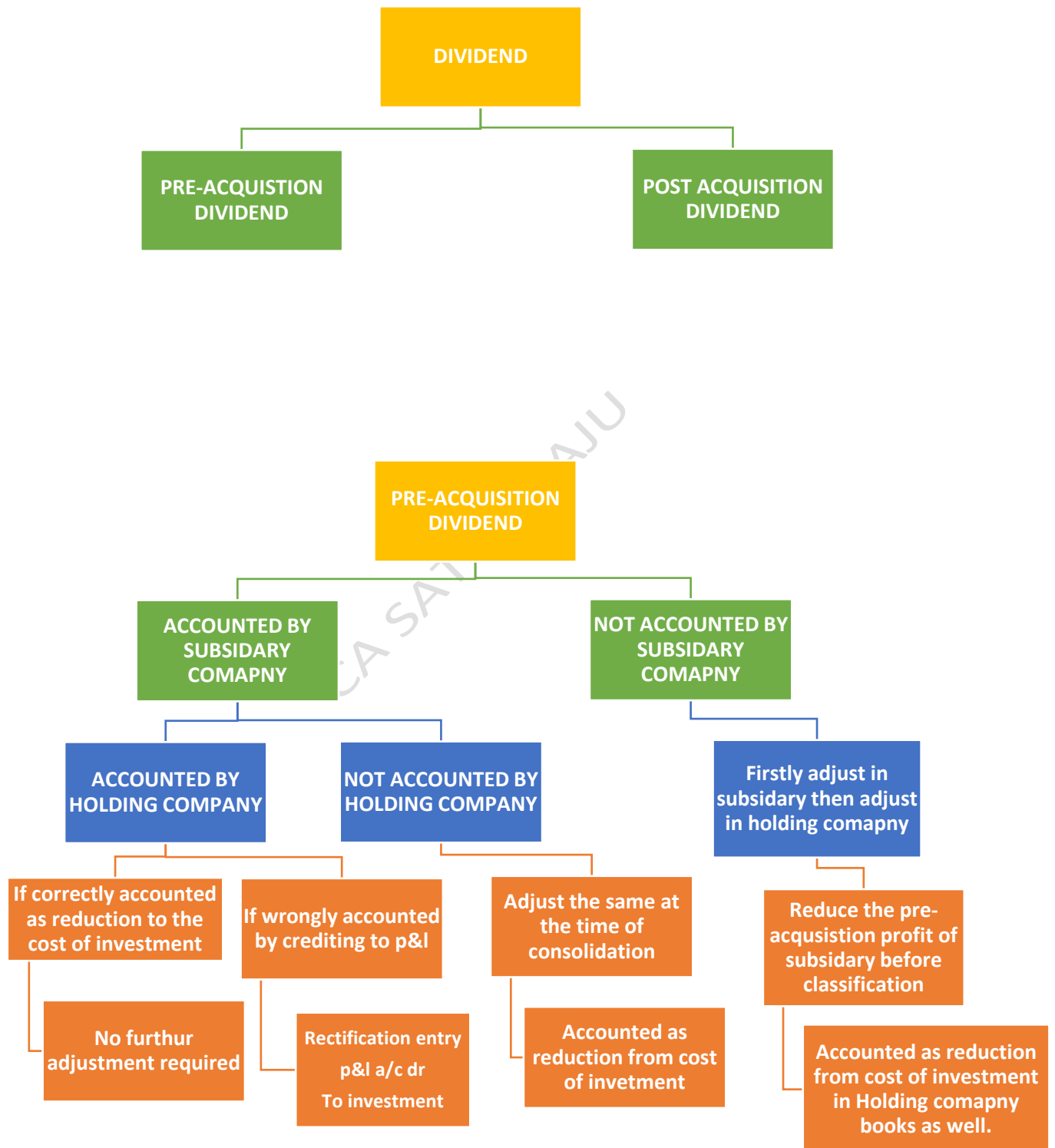
CHART D: CONSOLIDATED RESERVES & SURPLUS

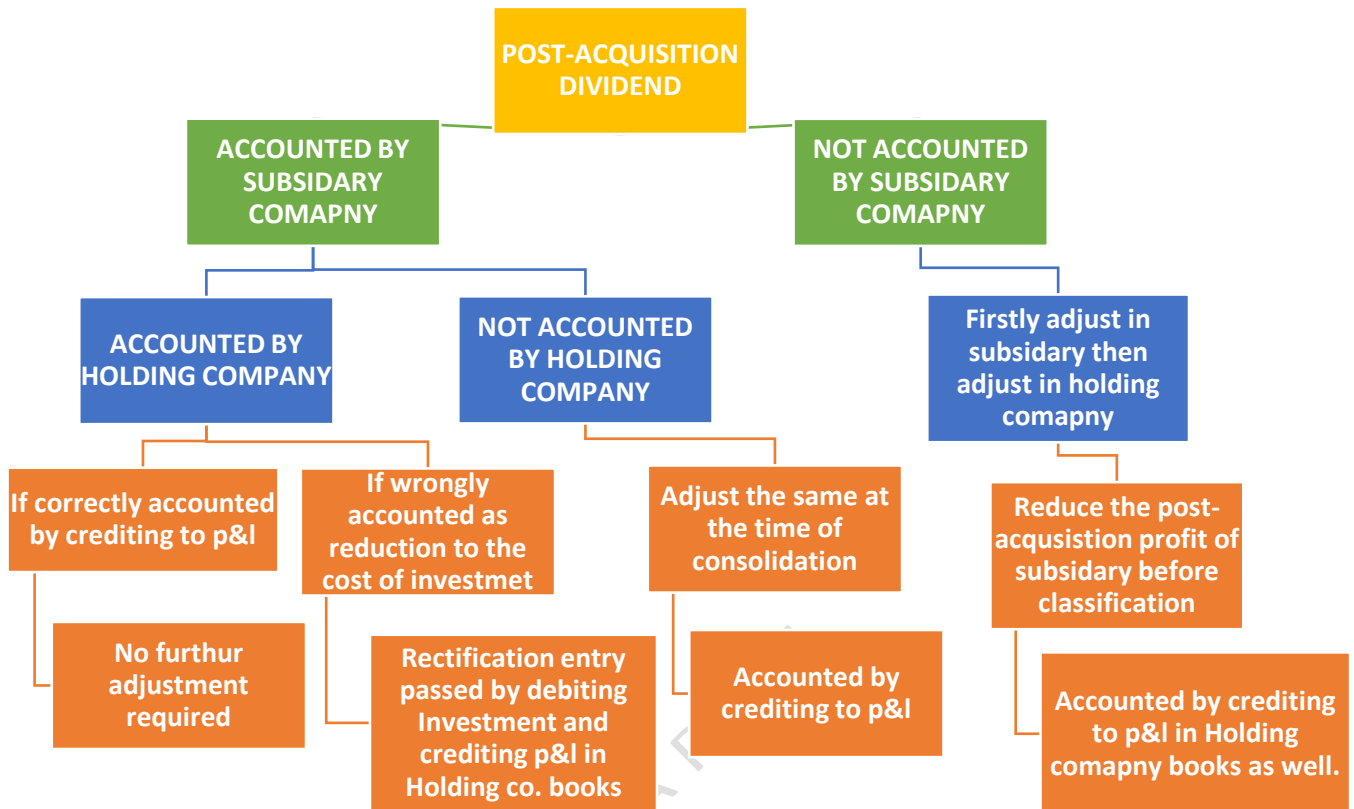
PARTICULARS	P&L	GR	STATUTORY RESERVE
Existing balance in Holding company	XXXX	XXXX	XXXX
ADD: Holding interest in revenue profits	XXXX	XXXX	XXXX
Reserves & surplus to be shown in CBS	XXXX	XXXX	XXXX

4. CONSOLIDATED BALANCE SHEET AS PER SCHEDULE III FORMAT

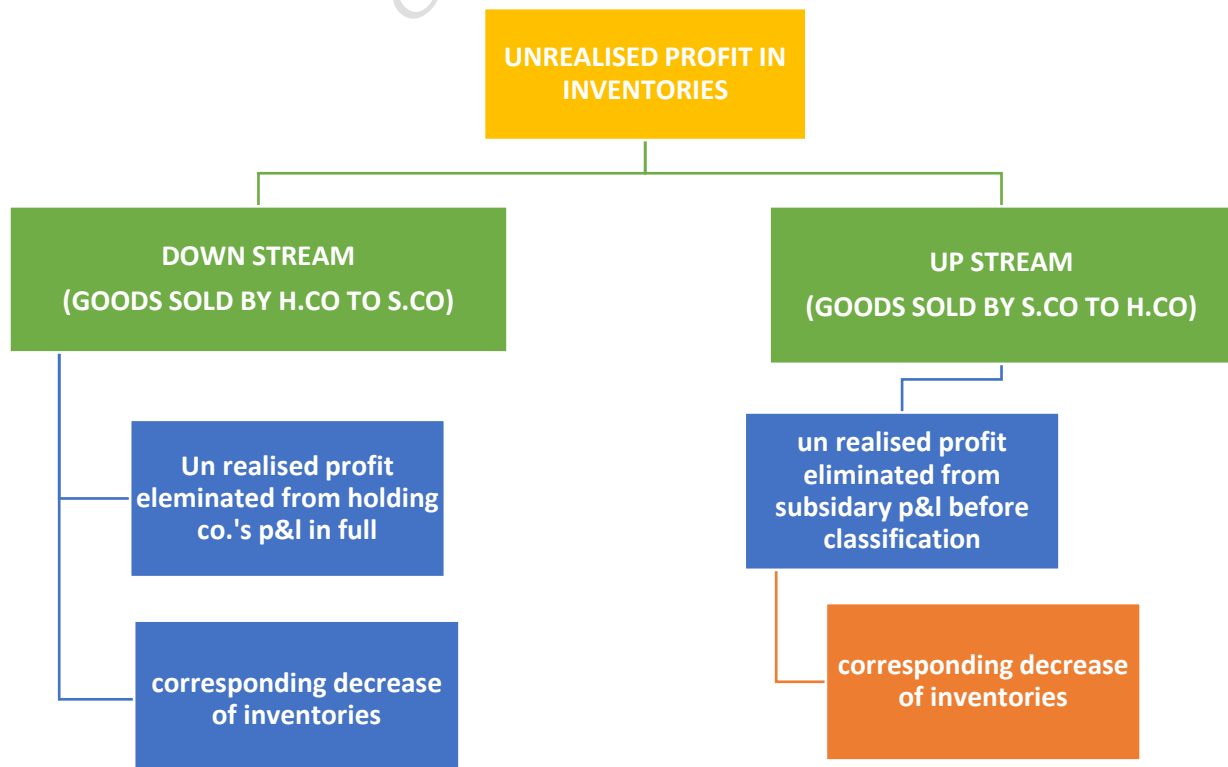
IMPORTANT ADJUSTMENTS:

1.





2.



- a. In the case of downstream transaction, the whole profit is earned by the holding company, therefore, whole unrealized profit should be adjusted from unsold inventory and consolidated profit and loss account only irrespective of the percentage of the shares held by the parent.
- b. In the case of upstream transaction, since the goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from subsidiary p&l before classification besides deducting the same from unsold inventory.

3. REVALUATION OF ASSETS OF SUBSIDIARY COMPANY:

- A. Profit or loss on revaluation of fixed assets of subsidiary should also be treated as capital profit or loss.
- B. But if the fall in the value of the asset occurs after the date of acquisition, the loss should be treated as revenue loss.
- C. Adjustment for Excess or Deficit depreciation due to revaluation would be made in the Revenue profits of the subsidiary under classification stage.
- D. Such Excess or Deficit depreciation need to be adjusted from carrying value of Asset in C.B.S as well.

4. UNIFORM ACCOUNTING POLICIES:

- A. AS 21 states that consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.
- B. If any company in the same group uses accounting policies other than those adopted in 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.
- C. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, the fact should be disclosed together with the proportions of items to which different accounting policies have been applied.

5. ALIGNMENT OF REPORTING DATES:

- A. The financial statements used in the consolidation should be drawn up to the same reporting date.

- B. 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.
- C. When the reporting dates are different, the subsidiary often prepares, for consolidation purposes, statements as at the same date as that of the parent.
- D. In any case, the difference between reporting dates should not be more than six months.

6. TREATMENT OF SUBSIDIARY COMPANY HAVING PREFERENCE SHARE CAPITAL:

- A. While preparing CFS, outstanding cumulative preference shares issued by a subsidiary are considered in the same manner as any other liability, such as debentures etc. Accordingly, the cost associated with such cumulative preference shares needs to be adjusted for.
- B. Therefore, while computing its share of profits or losses of the subsidiary, the parent should make adjustments in respect of preference dividends on outstanding cumulative preference shares issued by a subsidiary and held outside the group .since, for the group, such preference shares represent external liabilities. It would be appropriate for the parent to compute its share of profits or losses after adjusting for subsidiary's cumulative preference dividends, whether or not profits are available or dividends have been declared.
- C. However, in case of non-cumulative preference shares, no such adjustment is required unless the dividend is actually received.

PREPARATION OF CONSOLIDATED STATEMENT OF PROFIT AND LOSS:

- 1. All the items of profit and loss account are to be added on line by line basis and inter-company transactions should be eliminated from the consolidated figures.
- 2. For example, a holding company may sell goods or services to its subsidiary, receive consultancy fees, commission, royalty etc. These items are included in sales and other income of the holding company and in the expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These inter-company transactions are to be eliminated in full.
- 3. If there remains any unrealized profit in the inventory, of any of the Group Company, such unrealized profit is to be eliminated from the value of inventory to arrive at the consolidated profit.

PREPARATION OF CONSOLIDATED CASH FLOW STATEMENT:

1. As per AS 21, Consolidated cash flow statement is presented in case a parent presents its own cash flow statement.
2. For the purpose of preparation of consolidated cash flow statement, all the items of cash flow from operating activities, investing activities and financing activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated.

PROBLEMS FOR DISCUSSION**PROBLEM 1:**

From the following data, determine in each case:

1. Minority interest at the date of acquisition and at the date of consolidation.
2. Goodwill or Capital Reserve.
3. Amount of holding company's profit in the consolidated Balance Sheet assuming holding company's own Profit & Loss Account to be Rs.2,00,000 in each case:

	Subsidiary Company	% Shares Owned	Cost	Date of acquisition		Consolidation Date	
				1.1.2018		31.12.2018	
				Share Capital (Rs.)	P&L A/c (Rs.)	Share Capital (Rs.)	P&L A/c (Rs.)
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case.2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case.3	C	80%	56,000	50,000	20,000	50,000	20,000
Case.4	D	100%	1,00,000	50,000	40,000	50,000	55,000

(SM)

PROBLEM 2: XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st January, 2018 for Rs. 1,40,000. The issued capital of ABC Ltd., on 1st January, 2018 was Rs. 1,00,000 and the balance in the Profit & Loss Account was Rs. 60,000.

During the year ended 31st December, 2018, ABC Ltd. earned a profit of Rs. 20,000 and at year end, declared and paid a dividend of Rs. 15,000. Show by an entry how the dividend should be recorded in the books of XYZ Ltd.

What is the amount of minority interest as on 1st January, 2018 and 31st December, 2018? Also please check whether there should be any goodwill/capital reserve at the date of acquisition.

(ANS.: MINORITY INTEREST ON 01.01.18 - RS.32,000; MINORITY INTEREST ON 31.12.18 - RS.33,000 GOODWILL - RS.12,000)

PROBLEM 3:

Exe Ltd. acquires 70% of equity shares of Zed Ltd. as on 31st March, 2018 at a cost of Rs.70 lakhs. The following information is available from the balance sheet of Zed Ltd. as on 31st March, 2018:

	Rs. in lakhs
Fixed Assets	120
Investments	55
Current Assets	70
Loans & Advances	15
15% Debentures	90
Current Liabilities	50

The following revaluations have been agreed upon (not included in the above figures):

Fixed Assets Up by 20%
Investments Down by 10%

Zed Ltd. declared and paid dividend @ 20% on its equity shares as on 31st March, 2018. Exe Ltd. purchased the shares of Zed Ltd. @ Rs.20 per share. Calculate the amount of goodwill / capital reserve on acquisition of shares of Zed Ltd.

(SM) (ANS.: CAPITAL RESERVE: 33.95 LAKHS)

PROBLEM 4: H Ltd. acquired 3,000 shares in S Ltd., at a cost of Rs.4,80,000 on 31.7.2011. The capital of S Ltd. consisted of 5,000 shares of Rs.100 each fully paid. The Profit & Loss Account of this company for 2011 showed an opening balance of Rs.1,25,000 and profit for the year was Rs.3,00,000. At the end of the year, it declared a dividend of 40%. Record the entry in the books of H Ltd., in respect of Dividend for the following two situations:

- (1) The profit for 20X1 has been utilised to pay the dividend
- (2) Later profits have been utilised first and then pre- acquisition profits.

(Assume calendar year as financial year)

(SM)

PROBLEM 5:

- a. A Ltd holds 80% of the equity capital and voting power in B Ltd. A Ltd sells inventories costing Rs.180 lacs to B Ltd at a price of Rs. 200 lacs. The entire inventories remain unsold with B Ltd at the financial year end i.e. 31 March 2019.
- b. A Ltd holds 75% of the equity capital and voting power in B Ltd. A Ltd purchases inventories costing Rs. 150 lacs from B Ltd at a price of Rs. 200 lacs. The entire inventories remain unsold with A Ltd at the financial year end i.e. 31 March 2019.

Suggest the accounting treatment for the above mentioned transactions in the consolidated financial statements of A Ltd giving reference of the relevant guidance/standard.

(SM)

PROBLEM 6:

A Ltd. acquired 70% of equity shares of B Ltd. on 1.4.2011 at cost of Rs.10,00,000 when B Ltd. had an equity share capital of Rs.10,00,000 and reserves and surplus of Rs.80,000. In the four consecutive years, B Ltd. fared badly and suffered losses of Rs.2,50,000, Rs.4,00,000, Rs.5,00,000 and Rs.1,20,000 respectively. Thereafter in 2015 - 16, B Ltd. experienced turnaround and registered an annual profit of Rs.50,000. In the next two years i.e. 2016-17 and 2017-18, B Ltd. recorded annual profits of Rs.1,00,000 and Rs.1,50,000 respectively. Show the minority interests and cost of control at the end of each year for the purpose of consolidation.

(SM)(ANS.: MINORITY INTEREST ON 01.04.10: RS.3,24,000; COST OF CONTROL: RS.2,44,000)

PROBLEM 7:

On 31st March, 2015, P Ltd. acquired 1,05,000 shares of Q Ltd. for ` 12,00,000. The position of Q Ltd. on that date was as under:

	RS.
Property, plant and equipment	10,50,000
Current Assets	6,45,000
1,50,000 equity shares of ` 10 each fully paid	15,00,000
Pre-incorporation profits	30,000
Profit and Loss Account	60,000
Trade payables	1,05,000

P Ltd. and Q Ltd. give the following information on 31st March, 2021:

	P LTD	Q LTD
Equity shares of ` 10 each fully paid (before bonus issue)	45,00,000	15,00,000
Securities Premium	15,00,000	-
Pre-incorporation profits	-	30,000
General Reserve	60,00,000	19,05,000
Profit and Loss Account	15,75,000	4,20,000
Trade payables	5,55,000	2,10,000
Property, plant and equipment	79,20,000	23,10,000
Investment: 1,05,000 Equity shares in Q Ltd. at cost	12,00,000	-
Current Assets	44,10,000	17,55,000

Directors of Q Ltd. made bonus issue on 31.3.2021 in the ratio of one equity share of ` 10 each fully paid for every two equity shares held on that date. Bonus shares were issued out of post-acquisition profits by using General Reserve.

Calculate as on 31st March, 2021 (i) Cost of Control/Capital Reserve; (ii) Minority Interest; (iii) Consolidated Profit and Loss Account in each of the following cases:

(a) Before issue of bonus shares.

(b) Immediately after issue of bonus shares

(RTP-NOV 2021)

PROBLEM 8:

From the balance sheets and information given below, prepare Consolidated Balance sheet of Virat Ltd. and Anushka Ltd. as at 31st March. Virat Ltd. holds 80% of equity shares in Anushka Ltd. since its (Anushka Ltd. Rs.) incorporation.

Balance sheet of Virat Ltd. and Anushka Ltd. as at 31st March, 20X1

Particulars	Note No.	Virat Ltd. (Rs.)	Anushka Ltd. (Rs.)
1. Equity and Liabilities			
(1) Shareholder's Funds			
a) Share Capital	1	6,00,000	4,00,000
b) Reserves and Surplus	2	1,00,000	1,00,000
(2) Non-current liabilities			
Long term borrowings		2,00,000	1,00,000
(3) Current liabilities			
a) Trade payables		1,00,000	1,00,000
Total		10,00,000	7,00,000
2. Assets			
(1) Non-current assets			
a) Property, Plant and Equipment	3	4,00,000	3,00,000
b) Non-current investments		3,20,000	-
(2) Current assets			
a) Inventories		1,60,000	2,00,000
b) Trade receivables		80,000	1,40,000
c) Cash & cash Equivalents		40,000	60,000
Total		10,00,000	7,00,000

Notes to Accounts

	Particulars	Virat Ltd. (Rs.)	Anushka Ltd. (Rs.)
1	Share capital 60,000 equity shares of Rs. 10 each fully paid up 40,000 equity shares of Rs. 10 each fully paid up Total	6,00,000 --- <u>6,00,000</u>	--- <u>4,00,000</u> <u>4,00,000</u>
2	Reserves and Surplus General Reserve Total	<u>1,00,000</u> <u>1,00,000</u>	<u>1,00,000</u> <u>1,00,000</u>
3	Non-current investments Shares in Anushka Ltd	<u>3,20,000</u>	---

(SM)

PROBLEM 9:

From the following summarized balance sheets of H Ltd. and its subsidiary S Ltd. drawn up at 31st March, 2018, prepare a consolidated balance sheet as at that date, having regard to the following:

- i) Reserves and Profit and Loss Account of S Ltd. stood at Rs.25,000 and Rs.15,000 respectively on the date of acquisition of its 80% shares by H Ltd. on 1st April, 2017.
- ii) Machinery (Book-value Rs.1,00,000) and Furniture (Book value Rs.20,000) of S Ltd. were revalued at Rs.1,50,000 and Rs.15,000 respectively on 1st April, 2017 for the purpose of fixing the price of its shares. [Rates of depreciation computed on the basis of useful lives: Machinery 10%, Furniture 15%.]

Summarised Balance Sheet of H Ltd & S Ltd. as on 31st March, 2018

Liabilities	H Ltd. (Rs.)	S. Ltd. (Rs.)	Assets	H Ltd. (Rs.)	S. Ltd. (Rs)
Equity and Liabilities:			Non-current assets:		
Shareholders' funds			Fixed assets		
Share Capital			Machinery	3,00,000	90,000
Shares of Rs.100 each	6,00,000	1,00,000	Furniture	1,50,000	17,000
Reserves	2,00,000	75,000	Other non-current assets	4,40,000	1,50,000
Profit and Loss Account	1,00,000	25,000	Non-current Investments		
Trade Payables	1,50,000	57,000	Shares in S Ltd : 800 shares at Rs.200 each	1,60,000	
	10,50,000	2,57,000		10,50,000	2,57,000

(SM) (ANS.: MINORITY INTEREST: RS.48,150; GOODWILL: RS.12,000; CONSOLIDATED RESERVES & SURPLUS: RS.3,44,600)

PROBLEM 10:

On 31st March, 20X1, the balance sheets of H Ltd. and its subsidiary S Ltd. stood as follows:

**Balance sheet of H Ltd.
and its subsidiary S Ltd. as at 31st March, 20X1**

Particulars	Note No.	H Ltd. (Rs. In lakhs)	S Ltd. (Rs. in lakhs)
1. Equity and liabilities			
(1) Shareholder's Funds			
a) Share Capital	1	12,000	4,800
b) Reserves and Surplus	2	5,499	3,000
(2) Current Liabilities			
a) Trade payables		1,461	854
b) Short term provisions	3	855	394
c) Other current liabilities	4	1,572	160
Total		21,387	9,208
2. Assets			
(1) Non-current assets			
Property, Plant and Equipment	5	9,468	5,486
Non-current Investments (Shares in S ltd.)		3,000	
(2) Current assets			
Inventories		3,949	1,956
Trade receivables		2,600	1,363

Cash and cash equivalents		1,490	204
Short term loans and advances	6	520	
Other current assets	7	360	109
		21,387	9,208

Notes to Accounts:

	PARTICULARS	H Ltd.(Rs. in lakhs)	S Ltd.(Rs. in lakhs)
1	Share capital		
	Authorized share capital	15,000	6,000
	Equity shares of Rs. 10 each fully paid up		
	Issued and Subscribed:		
	Equity shares of Rs. 10 each fully paid up	<u>12,000</u>	<u>4,800</u>
	Total	<u>12,000</u>	<u>4,800</u>
2	Reserves and Surplus		
	General reserve	2,784	1,380
	Profit and loss account	<u>2,715</u>	<u>1,620</u>
	Total	<u>5,499</u>	<u>3,000</u>
3	Short term provisions		
	Provision for taxation	<u>855</u>	<u>394</u>
4	Other current liabilities		
	Bills payable	372	160
	Dividends payable	<u>1,200</u>	----
		<u>1,572</u>	<u>160</u>
5	Property, Plant and Equipment		
	Land and Buildings	2,718	--
	Plant and Machinery	4,905	4,900
	Furniture and Fittings	<u>1,845</u>	<u>586</u>
	Total	<u>9,468</u>	<u>5,486</u>
6	Short term loans and advances		
	Sundry advances	<u>520</u>	----
7	Other current assets		
	Bills receivable	<u>360</u>	<u>199</u>

The following information is also provided to you:

- H Ltd. purchased 180 lakh shares in S Ltd. on 31st March, 20X0 when the balances of General Reserve and Profit and Loss Account of S Ltd. stood at Rs. 3,000 lakh and Rs. 1,200 lakh respectively.
- On 1st April, 20X0, S Ltd. declared a dividend @ 20% for the year ended 31st March, 20X0. H Ltd. credited the dividend received by it to its Profit and Loss Account.
- On 1st January, 20X1, S Ltd. issued 3 fully paid-up bonus shares for every 5 shares held out of balances of its general reserves as on 31st March, 20X0.
- On 31st March, 20X1, all the bills payable in S Ltd.'s balance sheet were acceptances in favour of H Ltd. But on that date, H Ltd. held only Rs. 45 lakh of these acceptances in hand, the rest having been endorsed in favour of its trade payables.

- e) On 31st March, 20X1, S Ltd.'s inventory included goods which it had purchased for Rs. 100 lakh from H Ltd. which made a profit @ 25% on cost.

Prepare a consolidated Balance sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X1.

(SM) (ANS: CONSOLIDATED BALANCE SHEET OF H LTD. AND ITS SUBSIDIARY S LTD. AS AT 31ST

MARCH, 20X1- TOTAL: RS. 27,530)

PROBLEM 11:

Consider the following summarized balance sheets of subsidiary B Ltd.:

	2017(Rs.)	2018 (Rs.)		2017 (Rs.)	2018 (Rs.)
Share-Capital:			Fixed Assets:		
Issued & subscribed:			Cost	3,20,000	3,20,000
5,000 equity shares of Rs.100 each	5,00,000	5,00,000	Less: Accumulated depreciation	<u>(48,000)</u>	<u>(96,000)</u>
Reserves & Surplus:				2,72,000	2,24,000
Revenue reserves	2,86,000	7,14,000	Investments at cost	-	4,00,000
Current Liabilities & Provisions:			Current Assets:		
Trade Payables	4,90,000	4,94,000	Inventory	5,97,000	7,42,000
Bank overdraft	-	1,70,000	Trade Receivables	5,94,000	8,91,000
Provision for taxation	3,10,000	4,30,000	Prepaid Expenses	72,000	48,000
			Cash at Bank	51,000	3,000
	15,86,000	23,08,000		15,86,000	23,08,000

Also consider the following information:

- B Ltd. is a subsidiary of A Ltd. Both the companies follow calendar year as the accounting year.
- A Ltd. values inventory on weighted Average basis while B Ltd. used FIFO basis. To bring B Ltd.'s values in line with those of A Ltd. its value of inventory is required to be reduced by Rs.12,000 at the end of 2017 and Rs. 34,000 at the end of 2018.
- Both the companies use straight-line method of depreciation. However, A Ltd. charges depreciation @ 10%.
- B Ltd. deducts 1% from Trade Receivables as a general provision against doubtful debts.
- Prepaid expenses in B Ltd. include advertising expenditure carried forward of Rs. 60,000 in 2017 and Rs.30,000 in 2018, being part of initial advertising expenditure of Rs. 90,000 in 2017 which is being written off over three years. Similar amount of advertising expenditure of A Ltd. has been fully written off in 2017.

Restate the balance sheet of B Ltd. as on 31st December, 2018 after considering the above information, for the purpose of consolidation. Such restatement is necessary to make the accounting policies adopted by A Ltd. and B Ltd. uniform.

(SM)(ANS.: ADJUSTED REVENUE RESERVE - RS.6,91,000; BALANCE SHEET TOTAL - RS.22,85,000)

PROBLEM 12:

Given below are the Profit & Loss Accounts of H Ltd. and its subsidiary S Ltd. for the year ended 31st March, 2018:

(Rs. in Lakhs)

PARTICULARS	H Ltd.	S Ltd
Incomes:		
Sales and other income	5,000	1,000
Increase in Inventory	<u>1,000</u>	<u>200</u>
	6,000	1,200
Expenses:		
Raw material consumed	800	200
Wages and Salaries	800	150
Production expenses	200	100
Administrative Expenses	200	100
Selling and Distribution Expenses	200	50
Interest	100	50
Depreciation	<u>100</u>	<u>50</u>
	2,400	700
Profit before tax	3,600	500
Provision for tax	<u>(1,200)</u>	<u>(200)</u>
Profit after tax	2,400	300
Dividend paid	<u>(1,200)</u>	<u>(150)</u>
Balance of Profit	<u>1,200</u>	<u>150</u>

Other Information:

H Ltd. sold goods to S Ltd. of Rs.120 lacs at cost plus 20%. Inventory of S Ltd. includes such goods valuing Rs.24 lacs. Administrative expenses of S Ltd. include Rs.5 lacs paid to H Ltd. as consultancy fees. Selling and distribution expenses of H Ltd. include Rs.10 lacs paid to S Ltd. as commission.

H Ltd. holds 80% of equity share capital of Rs.1,000 lacs in S Ltd. prior to 2016-2017. H Ltd. took credit to its Profit and Loss Account, the proportionate amount of dividend declared and paid by S Ltd. for the year 2016-2017.

Prepare a consolidated profit and loss account of H Ltd. and its subsidiary S Ltd. for the year ended on 31st March, 2018.

(SM) (ANS.: PROFIT TO BE TRANSFERRED TO CONSOLIDATED BALANCE SHEET: RS.1,466 LAKHS)

TEST YOUR KNOWLEDGE

MCQ

1. Minority interest should be presented in the consolidated balance sheet

- (a) As a part of liabilities.
- (b) As a part of equity of the parent's shareholders.
- (c) Separately from liabilities and the equity of the parent's shareholders.

2. Minority of the subsidiary is entitled to

- (a) Capital profits of the subsidiary company.
- (b) Revenue profits of the subsidiary company.

(c) Both capital and revenue profits of the subsidiary company.

3. In consolidation of accounts of holding and subsidiary company _____ is eliminated in full.

- (a) Current liabilities of subsidiary company.
- (b) Reserves and surplus of both holding and subsidiary company.
- (c) Mutual indebtedness.

4. In consolidated balance sheet, the share of the outsiders in the net assets of the subsidiary must be shown as

- (a) Minority interest.
- (b) Capital reserve.
- (c) Current liability.

5. Taxation provision made by the subsidiary company will appear in the consolidated balance sheet as an item of

- (a) Current liability.
- (b) Revenue profit.
- (c) Capital profit.

6. Issue of bonus shares by the subsidiary company out of capital profits will

- (a) Decrease cost of control.
- (b) Increase cost of control.
- (c) Have no effect on cost of control.

7. Dividend paid by subsidiary to its parent, out of capital profits, should be credited by the parent company in its

- (a) Profit and loss account.
- (b) Dividend account.
- (c) Shares invested in subsidiary account.

8. Goodwill is equal to

- (a) Cost of Investment less Parent's share in the equity of the subsidiary on date of investment.
- (b) Cost of investment less Parent's share in the debentures of subsidiary on date of investment.
- (c) Parent's share in the equity of subsidiary on date of investment less Cost of investment.

9. If the subsidiary company follows weighted average method for valuation of inventories and the holding company follows FIFO method, then while consolidating,

- (a) Financial statements of subsidiary company should be restated by adjusting the value of inventories to bring the same in line with the valuation procedure adopted by the holding company

- (b) Financial statements of holding company should be restated by adjusting the value of inventories to bring the same in line with the valuation procedure adopted by the subsidiary company.
- (c) Financial statements of both companies may continue as per the basis followed by them.

10. If there remains any unrealized profit in the inventory, of any of the Group Company

- (a) Unrealized profit is added to value of inventory to compute consolidated profit.
- (b) Unrealized profit is reduced from value of inventory to compute consolidated profit.
- (c) No adjustment needs to be done.

11. Sahil Ltd acquired 45% of Rahil Ltd shares of ` 5,00,000 on 1.06.2019. By such an acquisition, Sahil Ltd can exercise significant influence over Rahil Ltd. During the financial year ending on 31.03.2019, Rahil Ltd earned profits 100,000 and declared a dividend of ` 75,000 on 13.09.2019. What is the carrying amount of investment in separate financial statements of Sahil Ltd as on 31.03.2020?

- (a) 4,66,250.
- (b) 7,81,250.
- (c) 4,28,000.

CA SATYA RAJU

9.ACCOUNTING FOR EMPLOYEE STOCK

OPTION PLANS

ESOP:

1. Employee stock option is a plan under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price.
2. Under the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.
3. Unlisted companies, in particular, start-up companies, often give share-based compensation since they cannot afford to pay high salaries to their employees but are willing to share the future prosperity of the company. Several companies also offer share-based payments to non-employees, including various vendors. It is hence important that cost relating to these recognised in the financial statements.

Why ESOPs?

- Link personal wealth creation to organizational creation
- Attract, reward, motivate and retain talent at the start-up/growth stage
- Deferred compensation strategy and good retirement benefit plan
- Reduction in cash costs – market pays not the Company
- Can be especially important for start-up Companies that are cash starved
- Promote employee ownership culture
- Helpful tool in cash crunch – In case of economic slow-down where companies are low at cash, they can motivate employee by offering ESOPs.

What Company sees while granting ESOPs to employees?

- Loyalty, Performance and Designation
- Present and Potential Contribution
- Opportunity Cost

Advantages of Employee Stock Option Plan to both the company and the employees:

1. Stock options provide an opportunity to employees to participate and contribute in the growth of the company.

2. Stock options create long term wealth in the hands of the employees.
3. They are important means to attract, retain and motivate the best available talent for the company.
4. It creates a common sense of ownership between the company and its employees.

The Guidance Note on Accounting for Share Based Payments (2020) is applicable for accounting of ESOPs for all enterprises that are not required to follow Indian Accounting Standards. The provisions of the Guidance Note cover employee stock option plans the grant date in respect of which falls on or after 1 April 2021.

A Share-based payment arrangement is 'an agreement between the enterprise and another party (including an employee) that entitles the other party to receive:

- (a) Cash or other assets of the enterprise for amounts that are based on the price (or value) of equity instruments of the enterprise, or
- (b) Equity instruments of the enterprise, provided the specified vesting conditions, if any, are met'.

A share-based payment transaction is a transaction in which the enterprise receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement.

Important terms

Share option is a contract that gives the holder the right, but not the obligation, to subscribe to the enterprise's shares at a fixed or determinable price for a specified period of time.

Grant Date is the date at which the enterprise and an employee agree to a employee stock option plan, being when the enterprise and the counterparty have a shared understanding of the terms and conditions of the arrangement. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

Measurement date is the date at which the fair value of the equity instruments granted is measured for the purposes of this Guidance Note. For transactions with employees, the measurement date is grant date.

Vest means to become an entitlement. Under an employee stock option plan, an employee's right to receive cash, other assets or equity instruments of the enterprise vests when the employee's entitlement is no longer conditional on the satisfaction of any vesting conditions.

Vesting Period is the period during which all the specified vesting conditions of an employee stock option plan are to be satisfied.

Exercise means making of an application by the counterparty for issue of equity instruments (including shares or share options) against the option vested in pursuance of employee stock option plan.

Exercise Period is the time period after vesting within which the counterparty should exercise his/her/its right to apply for equity instruments against the option vested in him in pursuance of the employee stock option plan.

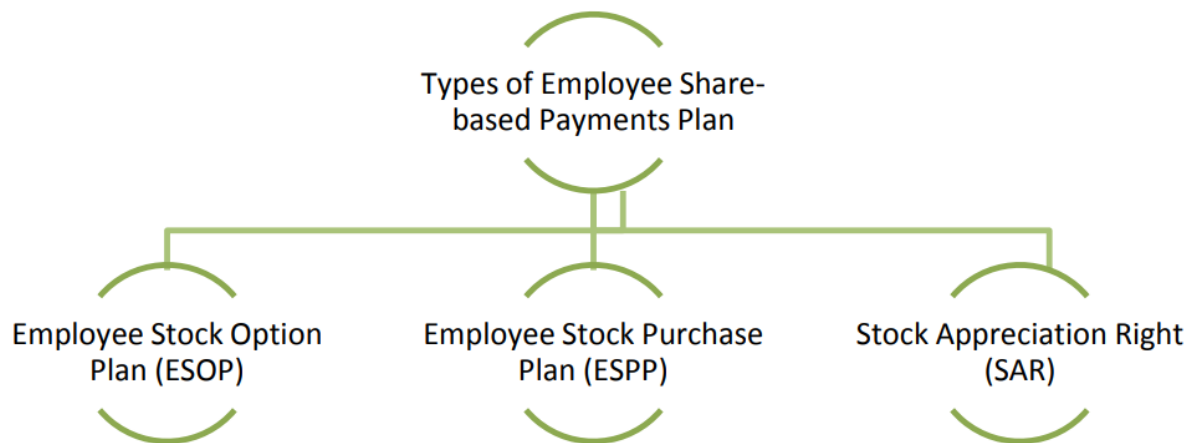
Exercise Price is the price payable by the counterparty for exercising the option granted to him/her/it in pursuance of the employee stock option plan.

Expected Life of an Option is the period of time from grant date to the date on which an option is expected to be exercised.

Provisions of Guidance Note on Accounting for Share-Based Payments

1. Scope of the Guidance Note establishes financial accounting and reporting principles for ESOPs. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.
2. The Guidance Note must be applied to all employee share based plans, including:
 - (a) equity-settled share-based payment transactions;
 - (b) cash-settled share-based payment transactions; and
 - (c) transactions where either the enterprise or the supplier of goods or services can choose whether the transaction is to be equity- settled or cash-settled.
3. The Scope of this Guidance Note extends to employee stock option plans between group enterprises.
4. For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee stock option plan .

TYPES OF EMPLOYEE SHARE BASED PAYMENTS:



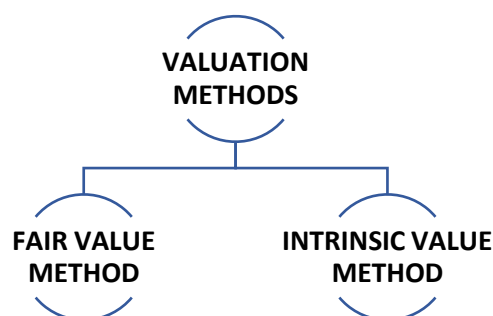
Classification of ESOPs for accounting purpose:

For accounting purposes, ESOPs are classified into the following categories:

- **Equity-settled** employee stock option plan is an employee stock option plan in which the enterprise receives services as consideration for its own equity instruments (including shares or share options), or receives services but has no obligation to settle the transaction with the employee.
- **Cash-settled** employee stock option plan is an employee stock option plan in which the enterprise acquires services by incurring a liability to transfer cash or other assets to the employee for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the enterprise or another group enterprise.
- **Employee share-based payment plans with cash alternatives:** Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

Accounting Procedure for ESOP:

1. An employee stock option plan within the scope for this Guidance Note can be accounted for by adopting the fair value method or the intrinsic value method.



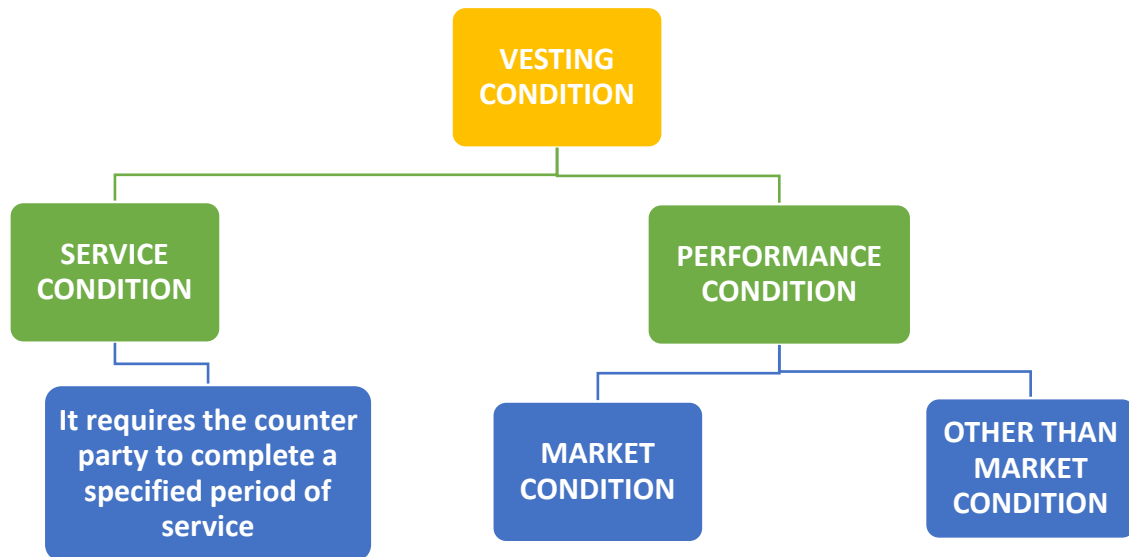
2. The accounting treatment recommended herein below is based on the fair value method as the Guidance Note recommends that accounting for share-based payment plans should be based on the fair value approach.
3. An enterprise shall recognise the services received in an employee stock option plan when the services are received.
4. The enterprise shall recognise a corresponding increase in equity if the services were received in an equity-settled employee stock option plan, or a liability if the services were received in a cash-settled employee stock option plan.
5. This account resulting from equity increase in an equity-settled employee stock option plan is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as per this Guidance Note.

Equity-settled employee stock option plan:

1. For equity-settled employee stock option plan, the enterprise shall measure the services received, and the corresponding increase in equity, directly, at the fair value of the services received, unless that fair value cannot be estimated reliably. If the enterprise cannot estimate reliably the fair value of the services received, the enterprise shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.
2. If the equity instruments granted vest immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. In the absence of evidence to the contrary, the enterprise shall presume that services rendered by the counterparty as consideration for the equity instruments have been received. In this case, on grant date the enterprise shall recognise the services received in full, with a corresponding increase in equity.
3. If the equity instruments granted do not vest until the counterparty completes a specified period of service, the enterprise should presume that the services to be rendered by the counterparty as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.
4. If an employee is granted share options conditional upon completing certain number of years' service, then the enterprise shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over that vesting period.

5. If an employee is granted share options conditional upon the achievement of a performance condition and remaining in the enterprise's employment until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The enterprise shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition.
6. If the performance condition is a market condition, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted and shall not be subsequently revised. If the performance condition is not a market condition, the enterprise shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.
7. To apply the requirements of the Guidance Note for the purpose of employee stock option plans, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest.
8. On exercise of the right to obtain shares or stock options, the enterprise issues share on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account).
9. In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

Vesting Condition is a condition that determines whether the enterprise receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the enterprise, under an employee stock option plan.



Performance condition is a vesting condition that requires:

- (a) the counterparty to complete a specified period of service (i.e. a service condition); the service requirement can be explicit or implicit; and
- (b) specified performance target(s) to be met while the counterparty is rendering the service required in (a).

A performance target is defined as

- (a) the enterprise's own operations or activities (Other than Market condition)
- (b) the price (or value) of the enterprise's equity instruments (Market condition)

Market condition is a performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the enterprise's equity instruments such as attaining a specified share price of a share option.

Treatment of vesting conditions:

1. The vesting conditions are either service conditions i.e a grant of shares to an employee is typically conditional on the employee remaining in the enterprise's employment for a specified period of time (or) Performance conditions i.e the enterprise achieving a specified growth in profit or a specified increase in the enterprise's share price.
2. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest.

3. Hence, on a cumulative basis, no amount is recognised for services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, e.g. the counterparty fails to complete a specified service period, or a performance condition is not satisfied.

Treatment after the vesting date

Having recognized the services received in accordance with the provisions of the Guidance Note, and a corresponding increase in equity, the enterprise shall make no subsequent adjustment to total equity after vesting date. the enterprise shall not subsequently reverse the amount recognised for services received from an employee if the vested equity instruments are not exercised. However, this requirement does not preclude the enterprise from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

Graded Vesting:

1. In case the options/shares granted under a share-based payment arrangement do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates.
2. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and accounted for accordingly.

Cash-settled employee stock option plans:

For cash-settled employee stock option plans, the enterprise shall measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise shall premeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

Examples

1. An enterprise might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of share options) that are redeemable, either mandatorily (e.g. upon cessation of employment) or at the employee's option.
2. An enterprise might grant share appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than an

equity instrument), based on the increase in the enterprise's share price from a specified level over a specified period of time.

Employee stock option plans with cash alternatives:

For employee stock option plans in which the terms of the arrangement provide either the enterprise or the counterparty with the choice of whether the enterprise settles the transaction in cash or by issuing equity instruments, the enterprise shall account for that transaction, as a cash settled share-based payment transaction if, and to the extent that, the enterprise has incurred a liability to settle in cash or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

DISCLOSURES:

1. An enterprise should describe the method used to account for the employee stock option plans.
2. A description of each type of employee stock option plan that existed at any time during the period.
3. the number and exercise prices of stock options.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

A company has its share capital divided into shares of Rs.10 each. On 1-4-2012, it granted 10,000 employees stock option at Rs.40, when the market price was Rs.130. The options were to be exercised between 15-03-2013 and 31-03-2013.

The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year. Show Journal Entries.

(SM)

PROBLEM 2:

ABC Ltd grants 1,000 employees stock options on 1.4.2010 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2012. 600 options are exercised on 30.6.2013. 100 vested options lapse at the end of the exercise period. Pass Journal Entries giving suitable narrations.

(SM)

PROBLEM 3:

Arihant Limited has its share capital divided into equity shares of Rs. 10 each. On 1-10-20X1, it granted 20,000 employees' stock options at Rs. 50 per share, when the market price was Rs. 120 per share. The options were to be exercised between 10th December, 20X1 and 31st March, 20X2. 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, 20X2.

(SM)

PROBLEM 4:

Ajanta grants 120 share options to each of its 460 employees. Each grant is conditional on the employee working for Ajanta over the next three years. Ajanta has estimated that the fair value of each share option is ` 12. Ajanta estimates that 25% of employees will leave during the three-year period and so forfeit their rights to the share options. Everything turns out exactly as expected. Required: Calculate the amounts to be recognized as expense during the vesting period.

PROBLEM 5:

P Ltd. granted option for 8,000 equity shares of nominal value of Rs.10 on 1st October, 2010 at Rs. 80 when the market price was Rs.170. The vesting period is 4½ year, 4,000 unvested options lapsed on 1st December, 2012, 3,000 options are exercised on 30th September, 2015 and 1,000 vested options lapsed at the end of the exercise period. Pass Journal Entries for above transactions.

(SM)

PROBLEM 6:

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2009 for Rs.20 depending upon the employees at the time of vesting of options. Options would be exercisable within a year it is vested. The market price of the share is Rs.50. These options will vest at the end of year 1 if the earning of Choice Ltd is 16%, or it will vest at the end of the year 2 if the average earning of two years is 13% or lastly it will vest at the end of the third year if the average earning of 3 years will be 10%. 5,000 unvested options lapsed on 31.03.2010, 4,000 unvested options lapsed on 31.3.2011 and finally 3,500 unvested options lapsed on 31.03.2012.

Following is the earning of Choice Ltd:

Year ended on	Earning (in %)
31.03.2010	14%
31.03.2011	10%
31.03.2012	7%

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

(SM)

PROBLEM7:

At the beginning of year 1, an enterprise grants 10,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. The exercise price is Rs. 40. However, the exercise price drops to Rs. 30 if the earnings of the enterprise increase by at least an average of 10 per cent per year over the three-year period.

On the grant date, the enterprise estimates that the fair value of the stock options, with an exercise price of Rs. 30, is Rs. 16 per option. If the exercise price is Rs. 40, the enterprise estimates that the stock options have a fair value of Rs. 12 per option.

During year 1, the earnings of the enterprise increased by 12 per cent, and the enterprise expects that earnings will continue to increase at this rate over the next two years. The enterprise, therefore, expects that the earnings target will be achieved, and hence the stock options will have an exercise price of Rs. 30.

During year 2, the earnings of the enterprise increased by 13 per cent, and the enterprise continues to expect that the earnings target will be achieved.

During year 3, the earnings of the enterprise increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested stock options have an exercise price of Rs. 40. Calculate the amount to be charged to Profit and Loss Account every year on account of compensation expenses. **(SM) (ANS.: YEAR 1-53,333, YEAR 2-53,334, YEAR 3 – 13,333)**

PROBLEM8:

On 1st April, 20X1, a company offered 100 shares to each of its 500 employees at ` 50 per share. The employees are given an year to accept the offer. The shares issued under the plan shall be subject to lock-in on transfer for three years from the grant date. The market price of shares of the company on the grant date is ` 60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ` 56 per share and fair value per option worked out to be ` 6. On 31st March, 20X2, 400 employees accepted the offer and paid ` 50 per share purchased. Nominal value of each share is ` 10. Record the issue of share in the books of the company under the aforesaid plan.

(SM-PRACTICAL QUESTION-4)

TEST YOUR KNOWLEDGE

MCQ

1. For accounting purposes, employee stock option plans are classified as
 - (a) Equity settled and cash settled.
 - (b) Liability settled and cash settled.
 - (c) Equity settled, cash settled and employees stock option plans with cash alternatives.

2. The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares is
 - (a) Exercise Price
 - (b) Intrinsic Value
 - (c) Fair value

3. Which amount would be recognized for employee stock option plans?
 - (a) Fair value of services received
 - (b) Amount as per agreement
 - (c) Fair value of equity instruments issued.

4. In line with the Guidance Note on Accounting for Share based Payments, an enterprise should recognize an amount for the services received from the employees

- (a) during the vesting period based on the best available estimate of the number of stock options expected to vest.
- (b) Immediately.
- (c) during the vesting period proportionately.

5. Which method is recommended for valuation of employee stock option plans by the Guidance Note on Accounting for Share Based Payments?

- (a) Intrinsic Value.
- (b) Fair value.
- (c) Both (a) and (b).

CA SATYA RAJU

10.BUYBACK OF SECURITIES AND EQUITY SHARES WITH DIFFERENTIAL RIGHTS

BUY- BACK OF SHARES:

1. Buy-back of shares means purchase of its own shares by a company.
2. When shares are bought back by a company, they have to be cancelled by the company. Thus, A company cannot buy its own shares for the purpose of investment.

ADVANTAGES OF BUY-BACK OF SHARES:

1. to increase earnings per share if there is no dilution in company's earnings as the buy-back of shares reduces the outstanding number of shares.
2. to increase promoters holding as the shares which are bought back are cancelled.
3. to discourage others to make hostile bid to take over the company as the buy-back will increase the promoters holding.
4. to support the share price on the stock exchanges when the share price, in the opinion of company management, is less than its worth, especially in the depressed market.
5. to pay surplus cash to shareholders when the company does not need it for business.

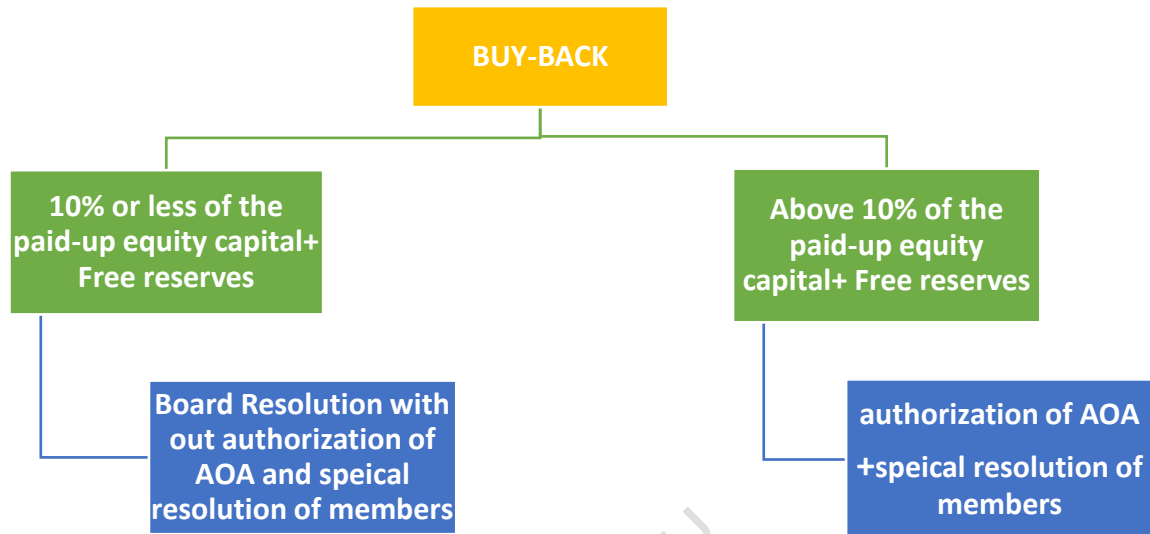
PROVISIONS OF COMPANIES ACT 2013 RELATING TO BUY-BACK:

1. The Companies Act, 2013 under Section 68 (1) permits companies to buy-back their own shares and other specified securities out of:
 - (i) its free reserves; or
 - (ii) the securities premium account; or
 - (iii) the proceeds of the issue of any shares or other specified securities.

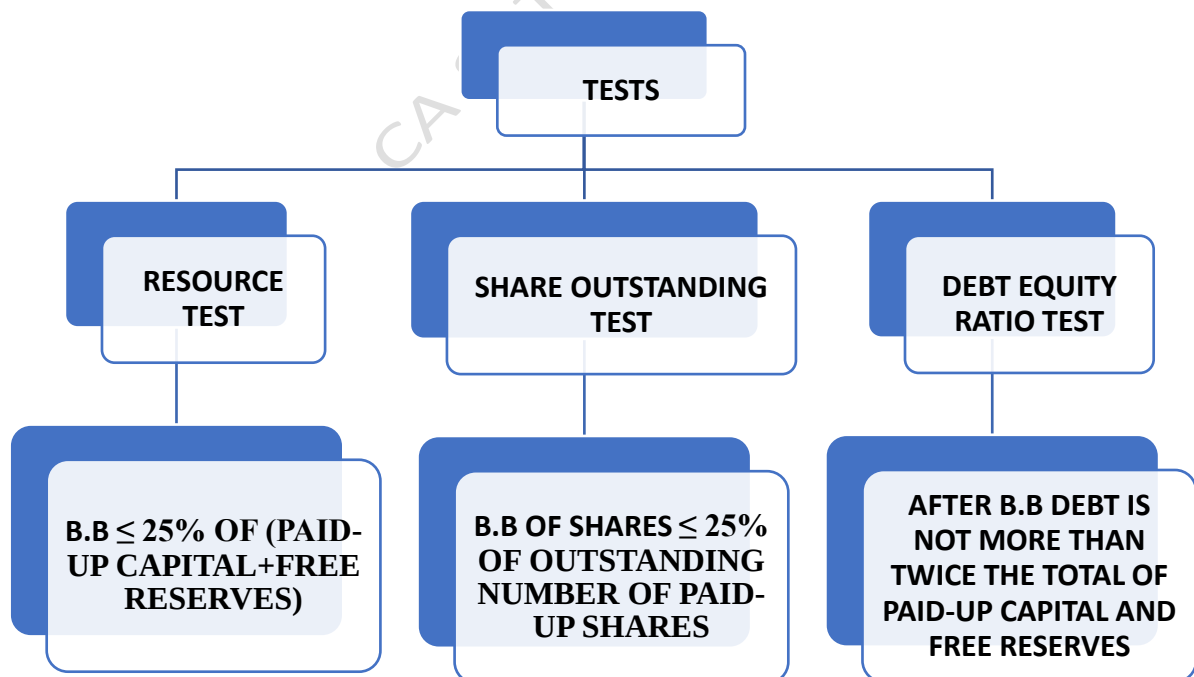
Note: No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities. For example, if equity shares are to be bought-back, then, preference shares may be used for the purpose.

2. Section 68(2)

A.



B. Maximum number of shares bought back will be lower of the results of below tests



3. All the shares or other specified securities for buy-back are fully paid-up;
4. No offer of the buy-back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy-back if any. This means that there cannot be more than one buyback in one year.
5. Every buy-back shall be completed within twelve months from the date of passing the special resolution, or the resolution passed by the board of directors.

6. The buy-back may be—
 - (a) from the existing security holders on a proportionate basis; or
 - (b) from the open market; or
 - (c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.
7. If company has passed a special resolution, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board of Directors has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board of Directors.
8. Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.
9. A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion.
10. Section 69 (1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.
11. 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.
12. Premium (excess of buy-back price over the par value) paid on buy-back should be adjusted against free reserves and/or securities premium account.

EXPLANATION:

For the purposes of Section 68

1. "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time
2. "free reserves" includes securities premium account.

JOURNAL ENTRIES:

PARTICULARS		DEBIT	CREDIT
Bank a/c To Investments a/c To P&I a/c	Dr.		
Equity share capital A/c Premium payable on buy-back A/c To Equity shares buy-back A/c	Dr. Dr.		
Equity shares buy-back A/c To Bank A/c	Dr.		
Securities premium/p&I A/c To Premium payable on buy-back A/c	Dr.		
Revenue reserve A/c To Capital Redemption Reserve A/c	Dr.		

NOTE: Above entries passed on the assumption that Buyback made by using existing resources. If buy back made from fresh issue of specified securities changes should be made accordingly.

Amount transferred to CRR and maximum equity to be bought back:

As per section 68 of the Companies Act, 2013, amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Equation 1:

Maximum permissible buy-back of equity= (Present equity sh's fund – Nominal value of buy-back transfer to CRR) – Minimum equity sh's fund to be maintained

Here Eq. sh's fund means Eq. share capital and free reserves & securities premium only.

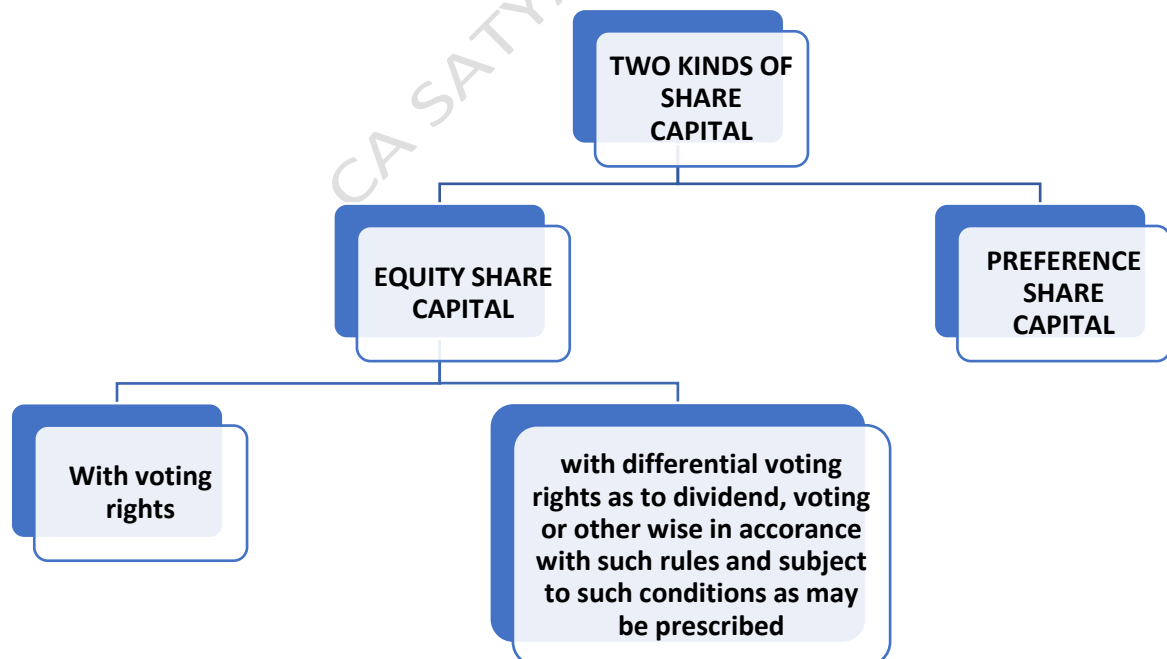
Equation 2:

Nominal value of the shares bought –back to be transferred to CRR =
Maximum buy-back X Face value
Buy back price

EQUITY SHARES WITH DIFFERENTIAL RIGHTS:

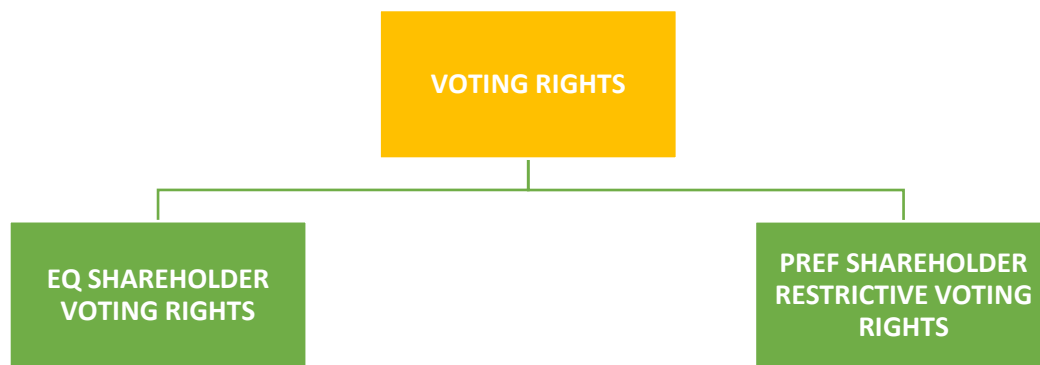
INTRODUCTION:

1. Section 43(a) of The Companies Act, 2013 defines equity share capital to include of two types viz.,
 - (i) With voting rights; or
 - (ii) With differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed
2. Differentiation can be done by giving superior dividend / Superior voting right/ diluted voting right to a class of equity shareholders. A residual category 'otherwise' has also been created to give enough leeway to the management in structuring shareholder agreements with desired divisions of managerial control interest and financial interest.
3. It must be appreciated that preference shares are not issued with differential rights. It is only the equity shares, which are issued.



VOTONG RIGHTS:

Section 2 (93) defines “voting right,” as the right of a member of a company to vote in any meeting of the company or by means of postal ballot.



Equity shareholder voting rights:

1. Equity shares have a general voting right, whereas preference shares have restrictive voting rights.
2. Every member of a company limited by shares and holding equity share capital therein, shall have a right to vote on every resolution placed before the company;
3. Normally, the blanket rule in Companies Act is one share-one vote. This gives equal voting right to every shareholder.
4. However, sometime a segment of shareholders, normally promoters and executive management may like to have more control over decision-making process. But that may not be possible if shareholding is quite diffused. This intention of shareholders / management can be activated if they have more voting rights, even if they hold fewer shares. This can be structured by giving them shares with superior voting rights. This is enabled by section 43(a)(ii) in the form of equity shares with differential rights.
5. If a company want to issue equity shares with differential rights, it should comply certain conditions as per Share Capital and Debentures Rules, 2014.
6. It is further clarified that the company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and vice-versa.
7. It is further clarified that the holders of the equity shares with differential rights shall enjoy all other rights such as bonus shares, rights shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued.

Example:

TATA were the first in 2008 to issue equity shares with differential rights. They came out with a differential right issue under the nomenclature of class A shares, the voting rights were diluted to 1/10th and the rate of the dividend was 5% more as compared to the other category of Tata motors shares being traded on the stock exchange.

Preference shareholder restrictive voting rights:

Normally preference shareholders have superior financial rights but less management control rights. Every member of a company limited by shares and holding any preference share capital therein shall, in respect of such capital, have a restrictive right to vote only on resolutions placed before the company.

- a. Which directly affect the rights attached to his preference shares and,
- b. Any resolution for the winding up of the company or
- c. For the repayment or
- d. Reduction of its equity or preference share capital.

Release of Preference shareholder restrictive voting rights:

It is provided further that where the dividend in respect of a class of preference shares has not been paid for a period of two years or more, such class of preference shareholders shall have a right to vote on **all the resolutions** placed before the company.

Relative weight of equity and preference share capital, when entitled to vote:

It is further provided that the proportion of the voting rights of equity shareholders to the voting rights of the preference shareholders shall be in the same proportion as the paid-up capital in respect of the equity shares bears to the paid-up capital in respect of the preference shares.

Example

Equity capital is held by X, Y and Z in the proportion of 40:40:20. A, B and C hold preference share capital in the proportion of 50:30:20. If the paid-up equity share capital of the company is ` 1 Crore and Preference share capital is ` 50 Lakh, then relative weight in the voting right of equity shareholders and preference shareholders will be $\frac{2}{3}$ and $\frac{1}{3}$. The respective voting right of various shareholders will be

X	=	$\frac{2}{3} \times \frac{40}{100}$	=	$\frac{4}{15}$
Y	=	$\frac{2}{3} \times \frac{40}{100}$	=	$\frac{4}{15}$
Z	=	$\frac{2}{3} \times \frac{20}{100}$	=	$\frac{2}{15}$
A	=	$\frac{1}{3} \times \frac{50}{100}$	=	$\frac{1}{6}$
B	=	$\frac{1}{3} \times \frac{30}{100}$	=	$\frac{1}{10}$
C	=	$\frac{1}{3} \times \frac{20}{100}$	=	$\frac{2}{30}$

Hence their relative weights are $\frac{4}{15} : \frac{4}{15} : \frac{2}{15} : \frac{1}{6} : \frac{1}{10} : \frac{2}{30}$ or 8:8:4:5:3:2. Their voting power is X (26.67%), Y (26.67%), Z (13.33%), A (16.67%), B (10%) and C (6.67%)

Variation of shareholder's rights:

1. The rights of a shares of a particular class, once issued, can be varied or altered under section 48 if
 - (a) The provision with respect to such variation is contained in the memorandum or articles of the company; or
 - (b) In the absence of any such provision in the memorandum or articles, if such variation is not prohibited by the terms of issue of the shares of that class.
2. However, it would require consent in writing of the holders of not less than three fourths of the issued shares of that class or by means of a special resolution passed at a separate meeting of the holders of the issued shares of that class.
3. However, the variation in their rights should not affect the rights of any other class, say Equity shares 'B' class or Preference shares. In such situation, if variation by one class of shareholders affects the rights of any other class of shareholders, the consent of three-fourths of such other class of shareholders shall also be obtained and the provisions of this section shall apply to such variation.

Share Capital and Debentures Rules, 2014, to deal with equity shares with differential rights:

1. The articles of association of the company authorizes the issue of shares with differential rights;
2. The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders.
3. 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;
4. The company having consistent track record of distributable profits for the last three years;
5. 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.
6. 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;
7. 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.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

M Ltd. furnishes the following summarized Balance Sheet as at 31st March, 2013:

Particulars	Rs.'000	Rs.'000
EQUITY & LIABILITIES:		
Share Capital:		
Authorized Capital:		5,000
Issued and Subscribed Capital:		
3,00,000 Equity shares of Rs.10 each fully paid up	3,000	
20,000 9% Preference Shares of 100 each	<u>2,000</u>	
		5,000
Reserve and Surplus:		
Capital reserve	10	
Revenue reserve	4,000	
Securities premium	500	
Profit and Loss account	<u>1,800</u>	6,310
Non-current liabilities - 10% Debentures		400
Current liabilities and provisions		<u>40</u>
		<u>11,750</u>
ASSETS:		
Fixed Assets: Cost	3,000	
Less: Provision for depreciation	<u>250</u>	2,750
Non-current investments at cost		5,000
Current assets, loans and advances (including cash and bank balances)		<u>4,000</u>
		<u>11,750</u>

The company passed a resolution to Buy-back 20% of its equity capital @ Rs.15 per share. For this purpose, it sold its investments of Rs.30 lakhs for Rs.25 lakhs.

You are required to pass necessary Journal entries

(SM)

PROBLEM 2:

Pratham Ltd. (a non-listed company) has the following Capital structure as on 31st March, 20X1:

Particulars	Rs.	Rs.
Equity Share Capital (shares of Rs. 10 each fully paid)		30,00,000
Reserves & Surplus		
General Reserve	32,50,000	
Security Premium Account	6,00,000	
Profit & Loss Account	4,30,000	
Revaluation Reserve	6,20,000	49,00,000
Loan Funds		42,00,000

You are required to compute by Debt Equity Ratio Test, the maximum number of shares that can be bought back in the light of above information, when the offer price for buy-back is Rs. 30 per share.

(SM)

PROBLEM 3:

Perrotte Ltd. (a non-listed company) has the following Capital Structure as on 31.03.20X1:

	Particulars		(Rs. in crores)
(1)	Equity Share Capital (Shares of Rs. 10 each fully paid)	---	330
(2)	Reserves and Surplus		
	General Reserve	240	
	Securities Premium Account	90	
	Profit & Loss Account	90	
	Infrastructure Development Reserve	180	600
(3)	Loan Funds		1,800

The Shareholders of Perrotte Ltd., on the recommendation of their Board of Directors, have approved on 12.09.20X1 a proposal to buy-back the maximum permissible number of Equity shares considering the large surplus funds available at the disposal of the company.

The prevailing market value of the company's shares is Rs. 25 per share and in order to induce the existing shareholders to offer their shares for buy-back, it was decided to offer a price of 20% over market.

You are also informed that the Infrastructure Development Reserve is created to satisfy Income-tax Act requirements.

You are required to compute the maximum number of shares that can be bought back in the light of the above information and also under a situation where the loan funds of the company were either Rs. 1,200 crores or Rs. 1,500 crores.

Assuming that the entire buy-back is completed by 09.12.20X1, show the accounting entries in the company's books in each situation.

(SM)

PROBLEM 4:

Anu Ltd. (a non-listed company) furnishes you with the following balance sheet as at 31st March, 20X1:

		Particulars	Notes	Rs. (in crores Rs.)
		Equity and Liabilities		
1		Shareholders' funds		
	A	Share capital	1	100
	B	Reserves and Surplus	2	300
2		Current liabilities		
	A	Trade Payables		<u>40</u>
		Total		<u>440</u>
		Assets		
1		Non-current assets		
	A	Property, plant and equipment	3	-
	B	Non-Current Investments	4	100
2		Current assets		
	A	Trade receivables		140
	B	Cash and Cash equivalents		<u>200</u>
		Total		<u>440</u>

Notes to accounts

No.	Particulars		Rs.
1	Share Capital		
	Authorized, issued and subscribed share capital:		
	12% Redeemable preference shares of Rs. 100 each, fully paid up		75
	Equity shares of Rs. 10 each, fully paid up		<u>25</u>
	Total		<u>100</u>
2	Reserves and Surplus		
	Capital reserve		15
	Securities premium		25
	Revenue reserves		<u>260</u>
	Total		<u>300</u>
3	Property, Plant and Equipment		
	PPE Cost		100
	Less: Provision for depreciation		<u>(100)</u>
	Net carrying value		<u>NIL</u>
4	Non-Current Investments		
	Non-current investments at cost (Market value Rs. 400 Cr.)		<u>100</u>

The company redeemed preference shares on 1st April, 20X1. It also bought back 50 lakhs equity shares of Rs. 10 each at Rs. 50 per share. The payments for the above were made out of the huge bank balances, which appeared as a part of current assets.

You are asked to:

SATYARAJU, FCA, DISA, B.COM

Casatyaraju2016@gmail.com

- (i) Pass journal entries to record the above.
(ii) Prepare balance sheet as at 1.4.20X1.

(SM)(ANS : balance sheet of Anu Ltd. as at 1.4.20X1. 340 crores)

PROBLEM 5:

Dee Limited (a non – listed company) furnishes the following balance sheet as at 31st March, 20X1:

(in thousand Rs.)

Particulars	Notes	Rs.
Equity and liabilities		
1 Shareholders' funds		
A Share capital	1	2,700
B Reserves and surplus	2	9,700
2 Current liabilities		
A Trade payables		1,400
Total		<u>13,800</u>
Assets		
1 Non – current assets		
A Property, plant and equipment		9,300
B Non – current investments		3,000
2 Current assets		
A Inventories		500
B Trade receivables		200
C Cash and cash equivalents		<u>800</u>
Total		<u>13,800</u>

Notes to accounts

1 Share capital		
Authorized, issued and subscribed capital:		
2,50,000 equity shares of Rs.10 each fully paid up		2,500
2,000, 10% preference shares of Rs.100 each (issued two months back for the purpose of buy – back)		200
Total		2,700
2 Reserves and surplus		
Capital reserve		1,000
Revenue reserve		3,000
Securities premium		2,200
Profit and loss account		<u>3,500</u>
Total		<u>9,700</u>

The company passed a resolution to buy – back 20% of its equity capital @ Rs.50 per share. For this purpose, it sold all of its investment for Rs.22,00,000

You are required to pass necessary journal entries and prepare the balance sheet.

(SM) (ANS : BALANCE SHEET OF DEE LTD. 1,05,00,000)

PROBLEM 6:

(in lakhs Rs.)

Particulars		Notes	Rs.
	Equity and liabilities		
1	Shareholder's funds		
	A Share capital	1	120
	B Reserve and surplus	2	118
2	Non – current liabilities		
	Long term borrowings	3	4
3	Current liabilities		
	A Trade payables		<u>70</u>
	Total		<u>312</u>
	Assets		
1	Non – current assets		
	A Property, plant and equipment		50
	B Non – current investments		120
2	Current assets		
	A Cash and cash equivalents		<u>142</u>
	Total		<u>312</u>

Notes to accounts

No.	Particulars	Rs.
1	Share Capital	
	Authorized, issued and subscribed capital:	
	Equity shares of Rs.10 each fully paid	100
	9% Redeemable preference shares of Rs.100 each fully paid	<u>20</u>
	Total	<u>120</u>
2	Reserves and Surplus	
	Capital reserves	8
	Revenue reserves	50
	Securities premium	<u>60</u>
	Total	<u>118</u>
3	Long term borrowings	
	10% Debentures	4

- The company redeemed the preference shares at a premium of 10% on 1st April, 20X1.
- It also bought back 3 lakhs equity shares of Rs.10 each at Rs.30 per share. The payment for the above was made out of huge bank balances.
- Included in its investment were "investments in own debentures" costing Rs.2 lakhs (face value Rs. 2.20 lakhs). These debentures were cancelled on 1st April 20X1.

- iv) The company had 1,00,000 equity stock options outstanding on the above- mentioned date, to the employees at Rs.20 when the market price was Rs.30 (This was included under current liabilities). On 1.04.20X1 employees exercised their options for 50,000 shares.
- v) Pass the journal entries to record the above.
- vi) Prepare Balance Sheet as at 01.04.20X1.

(SM) (ANS: BALANCE SHEET OF EXTRA LTD. RS. 2,08,00,000)

PROBLEM 7:

W, X, Y and Z hold Equity capital is held by in the proportion of 40:30:10:20. A, B, C and D hold preference share capital in the proportion of 30:40:20:10. If the paid- up capital of the company is ` 40 Lakh and Preference share capital is ` 20 Lakh, find their voting rights in case of resolution of winding up of the company. **(SM-PRACTICAL QUESTION 4)**

TEST YOUR KNOWLEDGE

1. As per section 68(1) of the Companies Act, buy-back of own shares by the company, shall not exceed
 - (a) 25% of the total paid-up capital and free reserves of the company.
 - (b) 20% of the total paid-up capital and free reserves of the company.
 - (c) 15% of the total paid-up capital and free reserves of the company.
2. The companies are permitted to buy-back their own shares out of
 - (a) Free reserves and Securities premium
 - (b) Proceeds of the issue of any shares.
 - (c) Both (a) and (b)
3. When a company purchases its own shares out of free reserves; a sum equal to nominal value of shares so purchased shall be transferred to
 - (a) Revenue redemption reserve.
 - (b) Capital redemption reserve.
 - (c) Buy-back reserve
4. Of the following, preference shareholders do not have a right to vote on resolutions
 - (a) Which directly affect the rights attached to his preference shares.
 - (b) For entering a private equity agreement to raise further capital diluting their overall stake in the company.
 - (c) For the repayment.
5. Preference shareholders will have a right to vote on all resolutions if the dividend on their share remains unpaid for

- (a) 1 year
- (b) 2 year
- (c) 3 year

6. The differential in the class of equity shares can be created for

- (a) Dividend.
- (b) Voting rights.
- (c) Both (a) and (b).

7. State which of the following statements is true?

- (a) Buy-back is for more than twenty-five per cent of the total paid-up capital and free reserves of the company.
- (b) Partly paid shares cannot be bought back by a company.
- (c) Buy-back of equity shares in any financial year shall exceed twenty-five per cent of its total paid-up equity capital in that financial year.

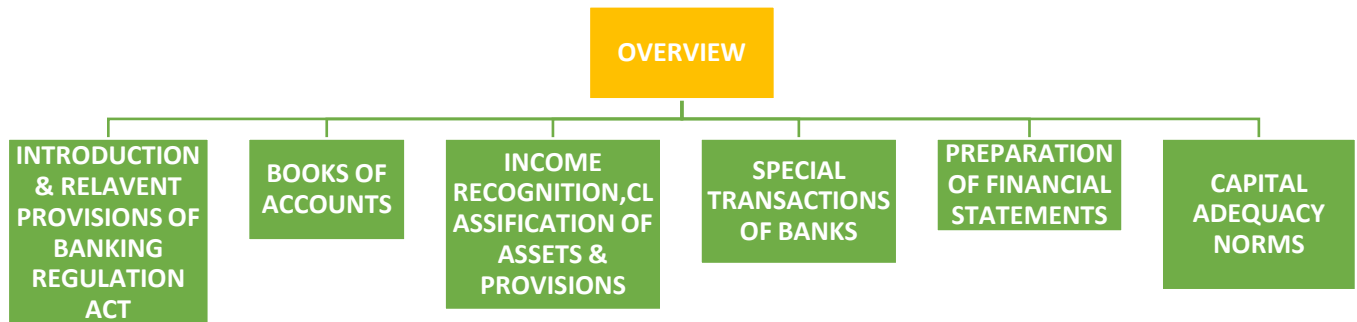
8. Premium (excess of buy-back price over the par value) paid on buy-back should be adjusted against

- (a) Free reserves.
- (b) Securities premium.
- (c) Both (a) and (b).

9. Advantages of Buy-back of shares include to

- (a) Encourage others to make hostile bid to take over the company.
- (b) Decrease promoters holding as the shares which are bought back are cancelled.
- (c) Discourage others to make hostile bid to take over the company as the buy-back will increase the promoters holding

11.BANKING COMPANIES

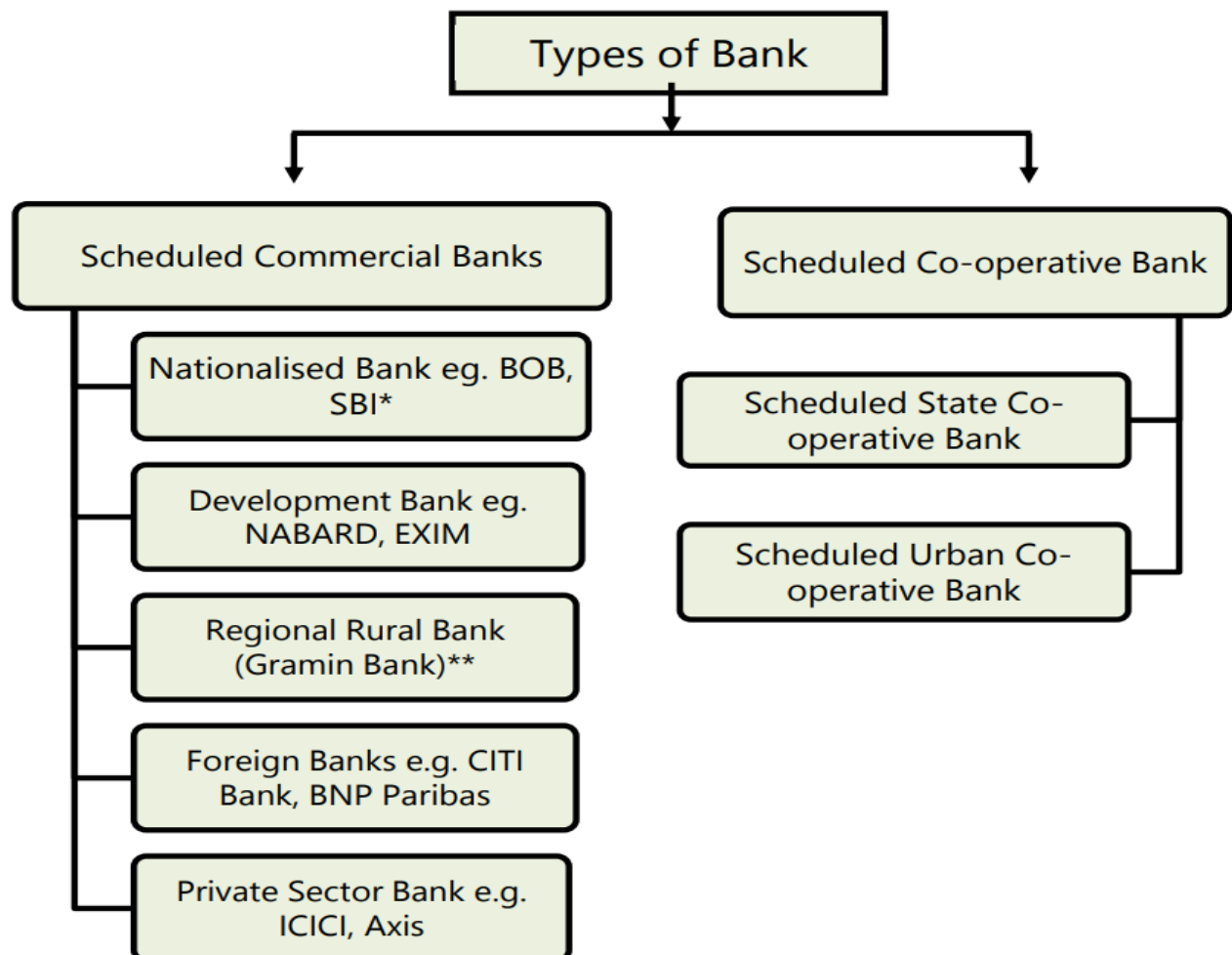


UNIT 1 INTRODUCTION & RELEVANT PROVISIONS OF BANKING REGULATION ACT

Banking: Under Section 5(b) of the Banking regulation act Act “Banking” means,

- Accepting deposits of money from public for the purpose of lending or investing
- These deposits are repayable on demand or otherwise, and can be withdrawn by cheque, draft or otherwise.

Banks in India and their activities are regulated by the Banking Regulation Act, 1949.



SCHEDULE BANKS in India constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. After May 1997 there are no non-scheduled commercial banks existing in India.

The banks included in this schedule list should fulfil following two conditions:

1. The paid -up capital and reserves in aggregate should not be less than ` 5 lakhs.
2. Any activity of the bank will not adversely affect the interests of depositors.

The Reserve Bank includes a bank in this schedule if it fulfils certain other conditions too.

RESERVE FUND:

Every banking company incorporated in India is required to create a Reserve Fund and to transfer at least 25% of its profit to the reserve fund as per RBI notification. The profit of the year as per the profit and loss account prepared under Section 29 is to be taken as base for the purpose of such transfer and transfer to reserve fund should be made before declaration of any dividend.

CASH RESERVE:

1. For smoothly meeting cash payment requirement, banks have to maintain certain minimum ready cash balances at all times. This is called as Cash Reserve Ratio (CRR).
2. Cash reserve can be maintained by way of either a cash reserve with itself or as balance in a current account with the Reserve Bank of India or by way of net balance in current accounts or in one or more of the aforesaid ways.
3. Every Scheduled Commercial Bank has to maintain cash reserve ratio (i.e. CRR) as per direction of the RBI issued under Section 42(IA) of the Reserve Bank of India Act, 1934.

LIQUIDITY NORMS:

1. Banking companies have to maintain sufficient liquid assets in the normal course of business called as Statutory Liquidity Ratio (SLR).
2. This safeguards the interest of depositors and prevents banks from over-extending their resources.
3. Every banking company has to maintain the SLR in the form of: cash, gold and unencumbered approved securities. The above assets have to be held at the close of business on any day and shall be valued at a price not exceeding the current market price of the above assets.
4. The percentage of SLR is changed by the Reserve Bank of India from time to time considering the general economic conditions. This is in addition to the Cash Reserve Ratio balance which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act.

UNIT 2 BOOKS OF ACCOUNTS

BANK BOOK- KEEPING SYSTEM:

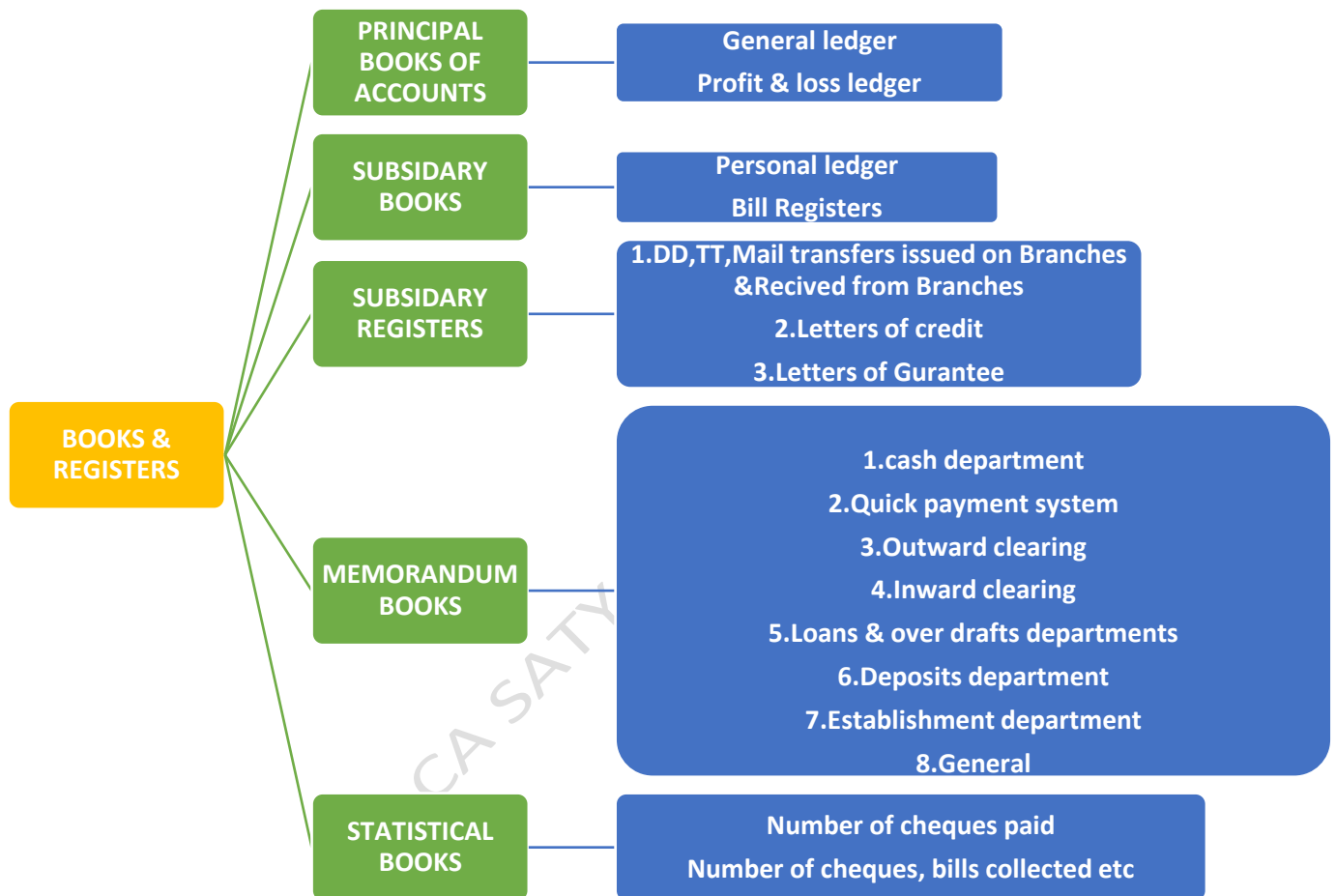
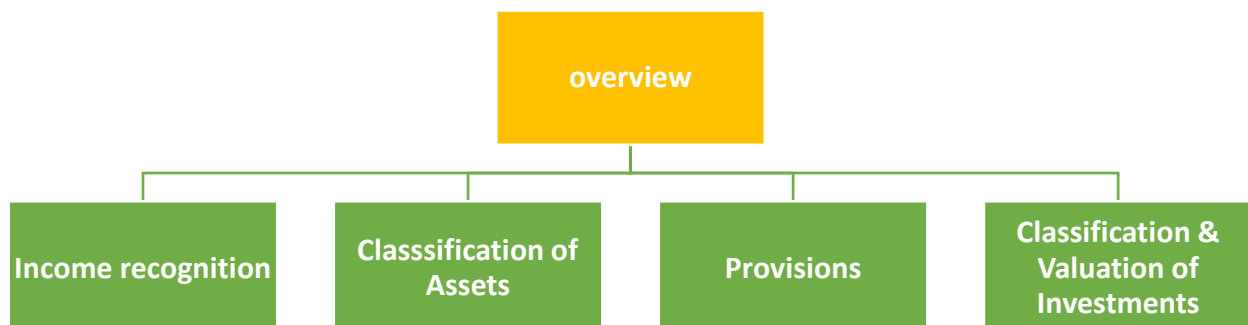
1. The book-keeping system of a banking company is substantially different from that of a trading or manufacturing enterprise.
2. In many other mercantile enterprises, books of primary entry (i.e., day books) are generally kept up-to-date while their ledgers including the general ledger and subsidiary ledgers for debtors, creditors etc. are written afterwards. However, a bank cannot afford to ignore its ledgers,

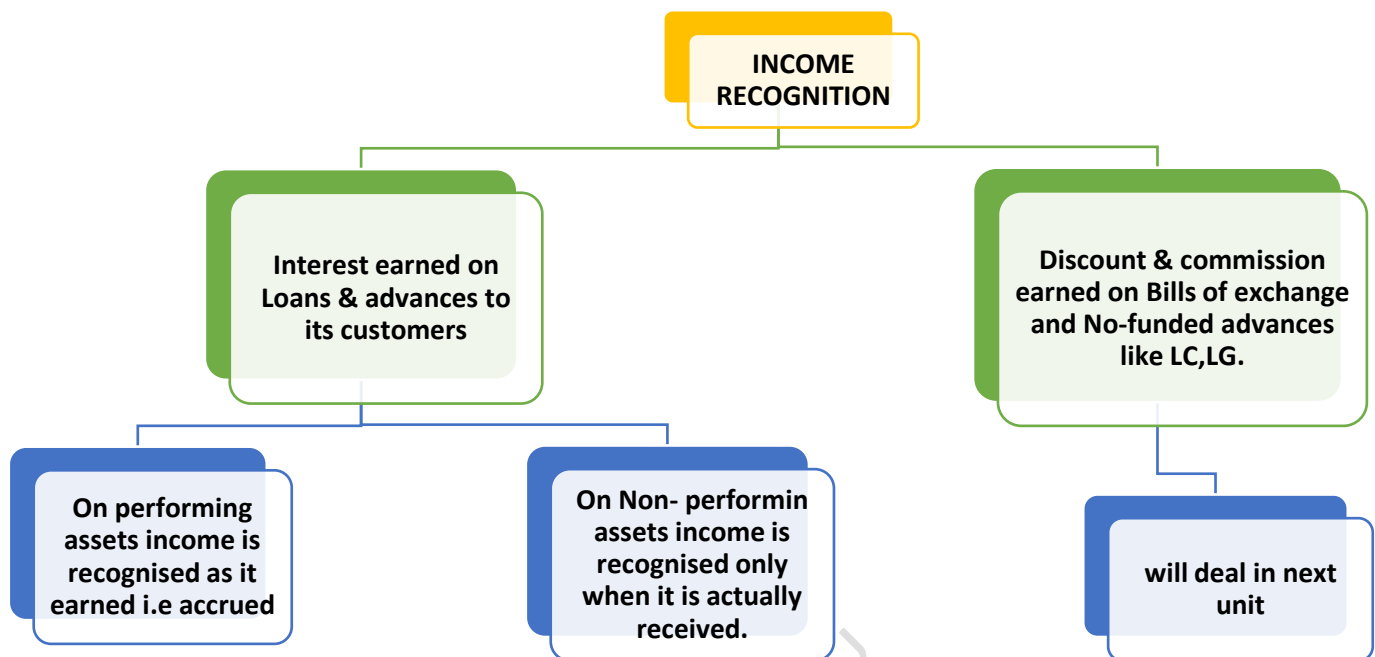
particularly those concerning the accounts of its customers and has to enter into the ledgers every transaction as soon as it takes place.

3. Banking company keep up- to- date detailed ledgers and to balance the trial balance every day and to keep all control accounts in agreement with the detailed ledger.
4. Presently most if not all of the Banks' accounting is done on Core Banking Solutions (CBS) wherein all accounts are maintained on huge servers with posting being affected instantly through vouchers, debit cards, internet banking etc.

MAIN CHARACTERISTICS OF A BANK'S BOOK-KEEPING SYSTEM:

- (a) **Voucher posting** – Vouchers are nothing but loose leaves of journals or cash books on which transactions are recorded as they occur. Entries in the personal ledger are made directly from vouchers instead of being posted from the books of prime entry. The bank has to ensure that customers (depositors) ledger accounts are up-to-date. It is therefore necessary that transactions in the bank are immediately recorded or are updated online. For this purpose slip system of ledger posting is adopted.
- (b) **Voucher summary sheets** - The vouchers entered in different personal ledgers each day are summarised on summary sheets, totals of which are posted to the control accounts in the general ledger.
- (c) **Daily trial balance** - The general ledger trial balance is extracted and agreed every- day.
- (d) **Continuous checks** - All entries in the detailed personal ledgers and summary sheets are checked by persons other than those who have made the entries. A considerable force of such check is employed, with the general result that most clerical mistakes are detected before another day begins.
- (e) **Control Accounts** - A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, agreed with general ledger control accounts.
- (f) **Double voucher system** - Two vouchers are prepared for every transaction not involving cash - one debit voucher and another credit voucher.

BOOKS AND REGISTERS MAINTAINED BY BANKING COMPANY:**UNIT 3: INCOME RECOGNITION, CLASSIFICATION OF ASSETS AND PROVISIONS**



Performing Asset:

Performing assets are Standard assets are those which do not disclose any problems and which does not carry more than normal risk attached to the business. Simply interest on those advances received regularly with out causing any problem.

Non-Performing asset:

NPA is other than performing asset.

Identification of NPA: The identification of NPA is determined on the basis of day past due basis and the same is reviewed at each reporting period.

1. **Bills purchased and discounted** become NPA if interest and / or instalment of principal remain overdue for a period exceeding 90 days.
2. **Term Loans**: become NPA if their amount (interest or principal) remain overdue wholly or partly for a period exceeding 90 days.
3. **A cash credit / overdraft** account is treated as NPA if it becomes **out of order**.

An account is treated as 'out of order' if any of the following conditions are satisfied:

- (a) The outstanding balance remains continuously in excess of the sanctioned limit/drawing power for a continuous period of 90 days prior to the Balance Sheet date.
- (b) Though the outstanding balance is less than the sanctioned limit/drawing power –
 - (i) there have been no credits for a continuous period of more than 90 days prior to the date of balance sheet; or

(ii) credits during the aforesaid period are not enough to cover the interest debited during the same period.

4. **Agricultural Advances**: Advances granted for agriculture purposes becomes NPA if interest and/or instalment of principal remains overdue for two crop seasons in case of short duration crops and a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

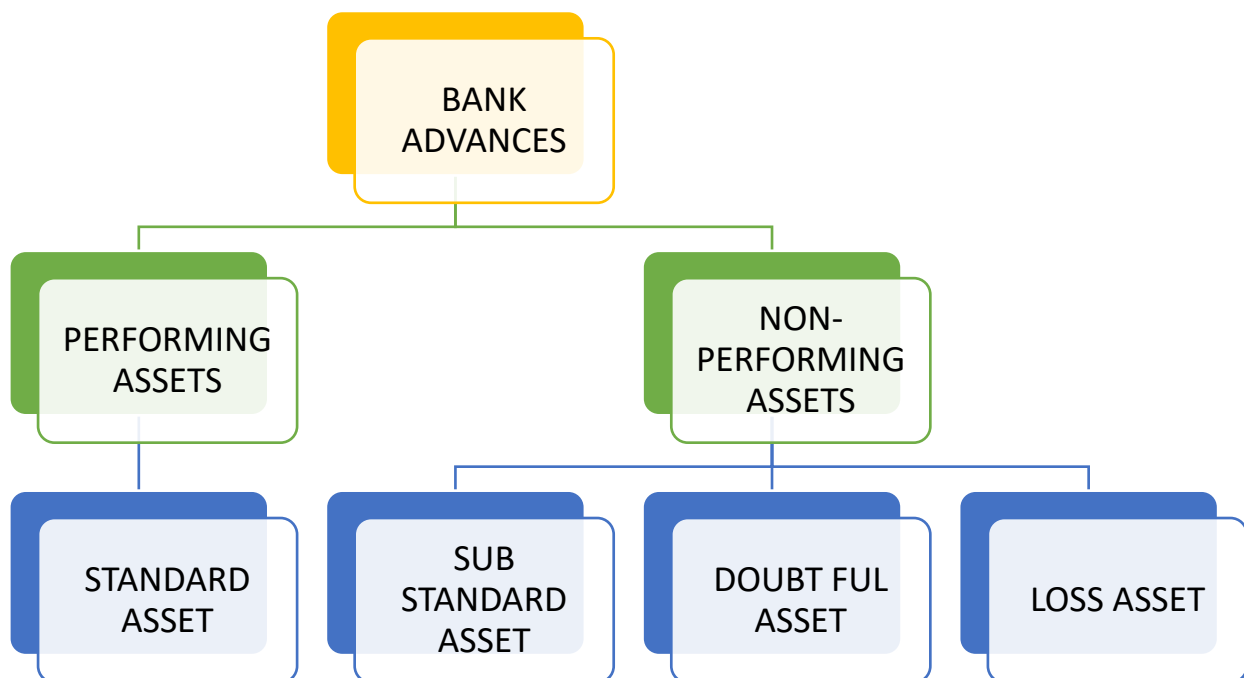
Long duration crops are those crops having crop season of more than one year and other crops will be treated as short duration crops.

5. **Advances Guaranteed by EXIM Bank**: In the case of advances covered under the guarantee-cum-refinance programme of EXIM Bank, to the extent payment has been received by the bank from the EXIM Bank, the advance may not be treated as NPA. The balance should, however, be treated as NPA

IMPORTANT POINTS RELATED TO NPA:

- (i) **Temporary Deficiencies**: The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement etc.
- (ii) **Determination of NPAs- Borrower-wise, Not Facility-wise**: If any of the credit facilities granted to a borrower becomes non-performing, all the facilities granted to the borrower will have to be treated as NPA without any regard to performing status of other facilities.

CLASSIFICATION OF BANK ADVANCES FOR CREATION OF PROVISION:



Standard assets are those which do not disclose any problems and which does not carry more than normal risk attached to the business.

Sub-standard asset is one which has been classified as an NPA for a period not exceeding 12 months.

Doubtful Assets - An asset would be classified as doubtful if it has remained in the substandard category for a period of at least 12 months.

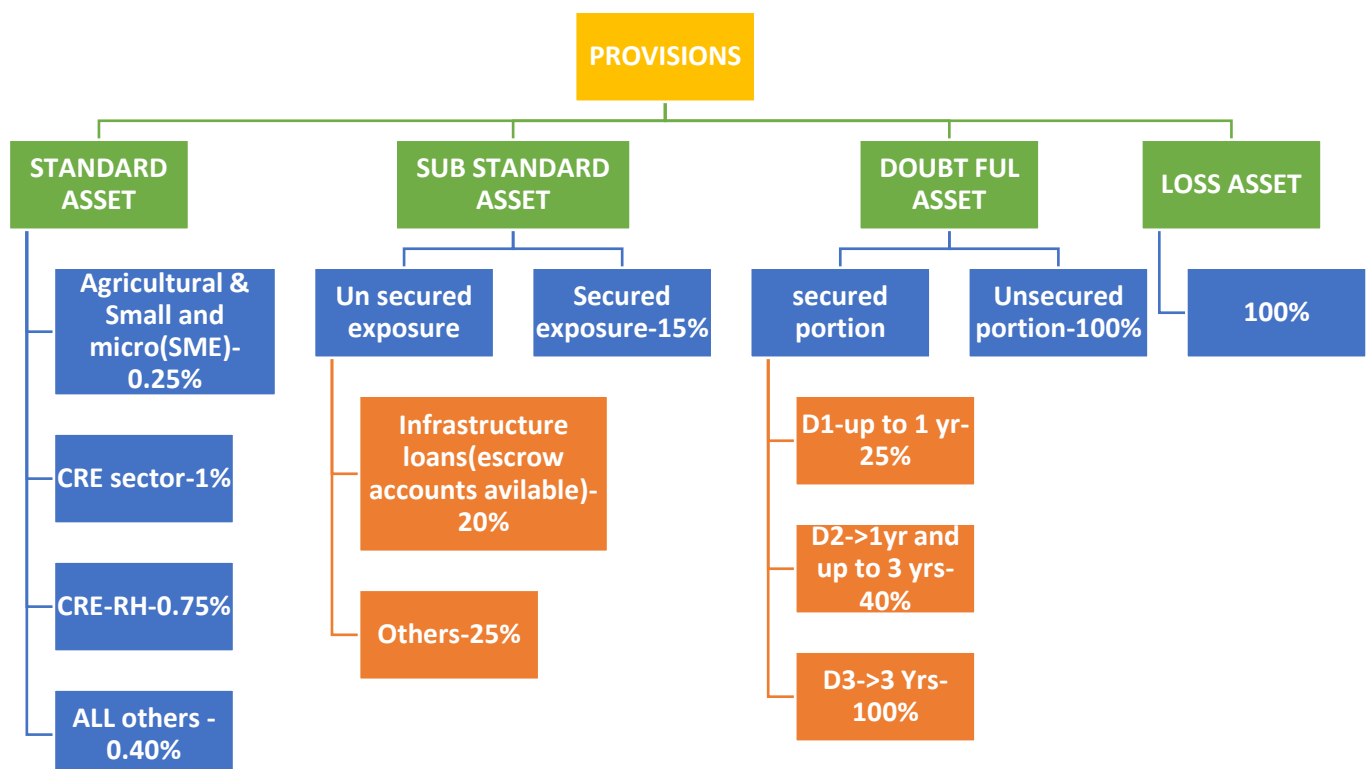
Loss Assets - A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspectors but the amount has not been written off, wholly or partly.

NOTES:

1. It may be noted that the above classification is meant for the purpose of computing the amount of provision to be made in respect of advances and not for the purpose of presentation of advances in the balance sheet. The balance sheet presentation of advances is governed by the Third Schedule to the Banking Regulation Act, 1949, which requires classification of advances altogether differently.

2. **Threats to Recovery:** It has been clarified, however, that in respect of accounts where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to clarify them first as sub-standard and thereafter as doubtful. Banks have been advised to classify such accounts straightway as doubtful or loss assets, as appropriate irrespective of the period for which the account has remained NPA.

PROVISIONS

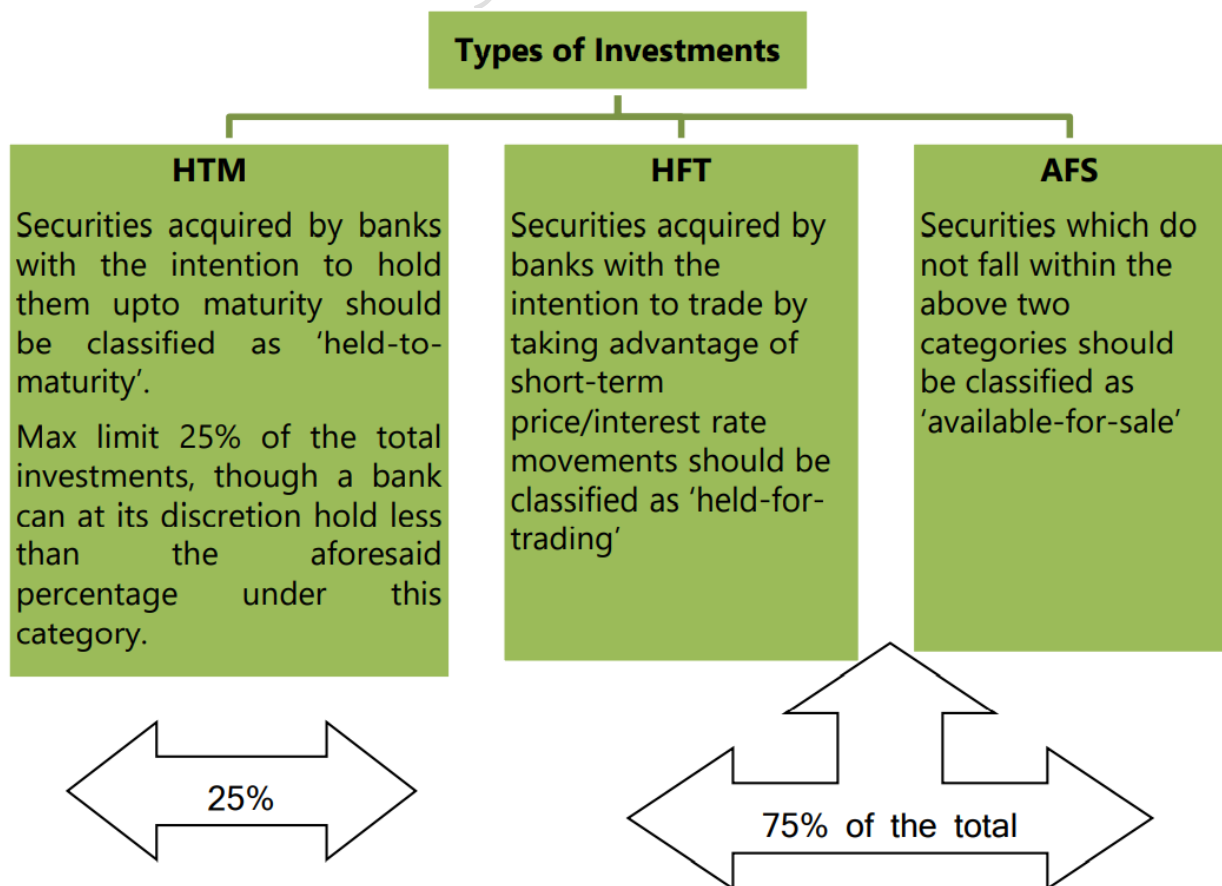


Notes:

1. It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning.
2. Accounting and Provisioning Norms for Equipment Leasing Activity: While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities.
3. Since no bank is likely to extend any loans or advances without adequate security, it is prudent to assume in the questions that even in the case of substandard or doubtful or loss assets, the same are secured unless the question specifically mentions otherwise.

Provisioning for advances covered by ECGC/DICGC guarantee:

1. In the case of advances guaranteed by Export Credit Guarantee Corporation (ECGC) or Deposit Insurance Credit Guarantee Corporation (DICGC), provision is required to be made only for the balance amount of advance outstanding in excess of the amount guaranteed by the corporations.
2. In case the bank also holds a security in respect of an advance guaranteed by ECGC/DICGC, the realisable value of the security should be deducted from the outstanding balance before the ECGC/DICGC guarantee is off-set.

CLASSIFICATION OF INVESTMENTS:

Held-to-Maturity, (HTM): Securities acquired by banks with the intention to hold them upto maturity should be classified as HTM.

Held-for-Trading (HFT): Securities acquired by banks with the intention to trade by taking advantage of short-term price/interest rate movements should be classified as 'held-for-trading'. These securities are to be sold within 90 days.

Available-for-Sale (AFS): Securities which do not fall within the above two categories should be classified as 'available-for-sale'. i.e Available-for-sale securities (AFS) are debt or equity securities purchased with the intent of selling before they reach maturity.

- Profit or loss on sale of investments in the categories HFT & AFS will be taken to the Profit and Loss Account.

Sale of Securities held in Held to Maturity (HTM) Category-Accounting treatment:

1. Investments by Primary (Urban) Co-operative Banks (UCBs), due to liquidity stress, required to sell securities from HTM portfolio, they may do so with the permission of their Board of Directors and rationale for such sale may be clearly recorded.
2. Profit on sale of investments from HTM category shall first be taken to the Profit and Loss account and, thereafter, the amount of such profit shall be appropriated to 'Capital Reserve' from the net profit for the year after statutory appropriations. Loss on sale shall be recognized in the Profit and Loss account in the year of sale.

SLR holdings in Held to Maturity (HTM category):

In reference to RBI circular dated October 12, 2020, banks are permitted to exceed the limit of 25 per cent of the total investments under Held to Maturity (HTM) category provided:

- (a) the excess comprises only of SLR securities; and
- (b) total SLR securities held under HTM category is not more than 19.5 per cent of Net Demand and Time Liabilities (NDTL) as on the last Friday of the second preceding fortnight.

VALUATION OF INVESTMENTS:

(a) Held-to-Maturity:

1. Investments classified under held-to-maturity category need not be marked to market. They should be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.
2. The bank should reflect the amortised amount in Schedule 13: Interest Earned – Item II 'Income on Investments' as a deduction. However, the deduction need not be disclosed separately. The

book value of the securities should continue to be reduced to the extent of the amount amortised during the relevant accounting period.

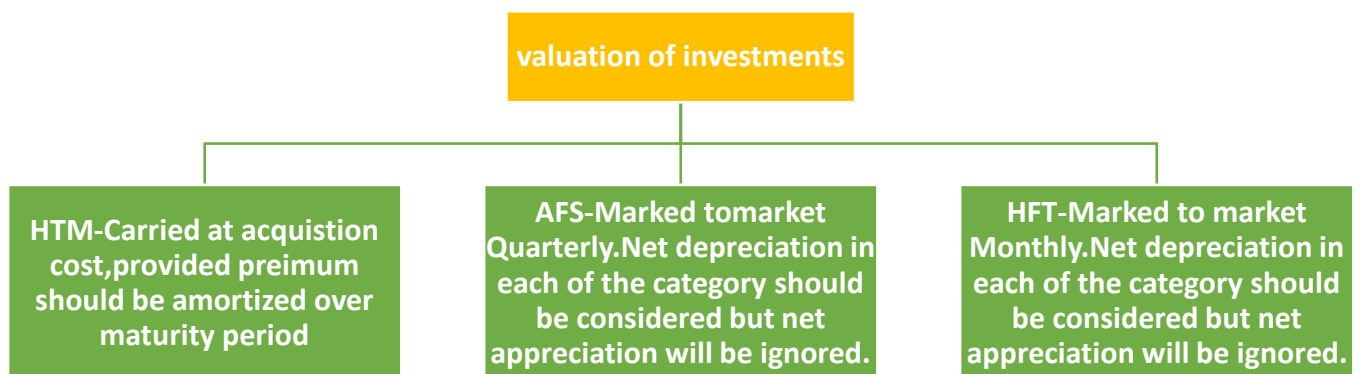
3. As per AS 13- only permanent diminution in the value of such investments under held-to-maturity category should be provided for. Such diminution should be determined and provided for each investment individually.

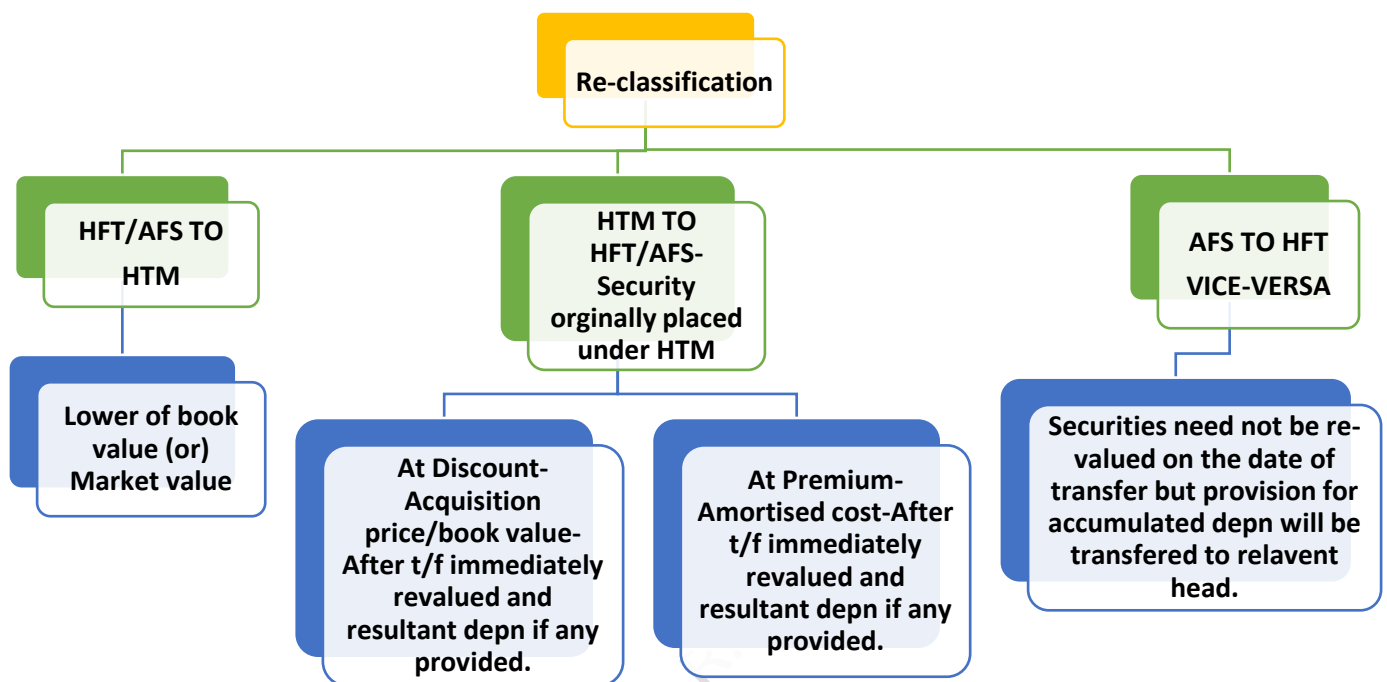
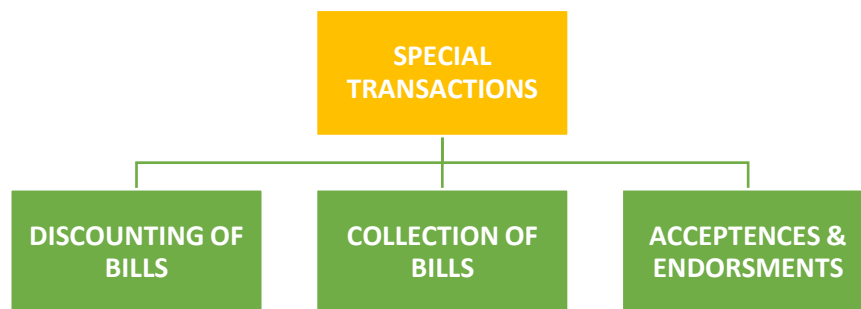
(b) **Available-for-sale:**

1. The individual scrips in the available-for-sale category should be marked to market **quarterly or at more frequent intervals**.
2. While the net depreciation under each of the categories (required by third schedule to Banking Regulation Act, 1949) should be recognised and fully provided for, the net appreciation under any of the aforesaid categories above should be ignored.
3. Thus, banks can offset gains in respect of some investments marked-to-market within a category against losses in respect of other investments marked-to-market in that category. The guidelines however, do not permit offsetting of gains and losses across different categories.
4. The book value of the individual securities would not have undergone any change after the marking to market. In other words, the depreciation or appreciation in value of individual scrips in accordance with the above methodology would not be credited to individual scrip accounts but would be held collectively in a separate account.

(c) **Held-for-trading:**

1. The individual scrips in the 'held-for-trading' category should be marked to market at **monthly or at more frequent intervals** and provided for as in the case of those in the 'Available for sale' category.
2. Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.



Re-classification of investments:**UNIT4 -SPECIAL TRANSACTIONS OF BANK****Discounting of bills:**

1. A bank may straight away purchase a Bill (Discounting). In this case after reducing discount charges, the balance amount is credited to the account of the customer. The total of both is debited to 'Bills purchased and discounted account'. This account is an Asset.

Bills purchased & Discounted a/c	Dr	XXXX
To Discount on Bills discounted a/c		XXXX
To Customer a/c		XXXX

2. Rebate on Bills Discounted:

- (i) Banks discount hundreds of bills every day and when someone gets a bill discounted, the bank credits the discount account with the full amount of the discount, the bank will earn in respect

of that bill. But in practice, it frequently happens that some of these bills will not mature by the close of the accounting year. The portion of the discount which relates to the period falling after the close of the accounting period is called 'rebate on bills discounted', or 'unearned discount'.

- (ii) Since discount on bill discounted is an income for the bank and is shown in the Profit & Loss Account under schedule 13, the amount of unexpired discount, if given in the adjustments, is deducted from schedule 13 and is also shown on the liabilities side of the balance sheet in the item 'other liabilities and provisions' in schedule 5.

Discount on Bills discounted a/c	Dr	XXXX	
To Rebate on bills discounted a/c			XXXX

- (iii) The Rebate A/c is shown on the liability side of the Balance Sheet as income received which has not accrued before the close of the year. Immediately on commencement of next financial year the Rebate A/c is closed by transfer to the credit of Discount A/c.

Rebate on bills discounted a/c	Dr	XXXX	
To Discount on Bills discounted a/c			XXXX

Collection of Bills:

1. One of the services provided by banks to their customers is to collect the dues against Bills of Exchange from their customers on the due dates.
2. Where the bills have been discounted the proceeds of such bills on due date are treated as incomes of the bank. On the other hand, if bills have not been discounted, the proceeds on the same on maturity are credited to the account of the customer.
3. The particulars will be recorded in a separate book called Bills for Collection Register. Bills sent for collection have to be shown by way of Note as per Third Schedule.
4. Two Accounts have to be opened. They are mirror images of each other. They are:
 - (i) Bills for Collection (Asset)
 - (ii) Bills for Collection (Liability)

Acceptance and Endorsement:

1. A bank has more acceptable credit as compared to that of its customer, because of this, more often, the bank is called to accept or endorse a bill on behalf of its customers. The bank has to honour this acceptance on behalf of its client only in the event of a client failing to honour the bill on the due date.
2. As against this liability, the bank has a corresponding claim against the customer on whose behalf it has undertaken to be a party to the bill, either as an acceptor or as an endorser. As a safeguard against the customer not being able to meet the demand of the bank in this respect, usually the bank requires the customer to deposit a security equivalent to the amount of the bill accepted on his behalf.
3. Such Acceptance (Liabilities) which are outstanding at the close of the year and the corresponding asset (security) is disclosed as Contingent liability.

4. If the bill, at the end of its term, has to be retired by the bank and the amount cannot be collected from the customer on demand, the bank reimburses itself by disposing of the security deposited by the customer.

OTHER SERVICES:

The transactions entered into for rendering other services e.g., collection of dividend and interest, making periodical payments etc. do not involve any complicated accounting. Basically, when any amount is collected for a customer as dividend or interest, his account is credited and cash is debited. Correspondingly, wherever any payment is made on account of a customer, his account is debited and cash is credited. Usually a separate charge is made for such a service.

UNIT 5-PREPARATION OF FINANCIAL STATEMENTS OF BANKS



RBI Monetary policy 2021:

<u>Indicator</u>	<u>Current rate</u>
CRR	4.00%
SLR	18.00%
Repo rate	4.00%
Reverse Repo rate	3.35%
Bank rate	4.25%

Note: 1.Above rates are indicative only. RBI will change the Monetary policy tools to increase or decrease the supply of money, from time to time.

2.As per ICAI resource, SLR used @ 23%.

**New Revised Formats
The Third Schedule
(See Section 29)**

Form 'A'

Form of Balance Sheet

Balance Sheet of _____(here enter name of the Banking company)

Balance Sheet as on 31st March (Year)

(000's)

	Schedule	As on 31.3.... (Current year)	As on 31.3..... (Previous year)
Capital & Liabilities			
Capital	1		
Reserve & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5	_____	_____
Total		_____	_____
Assets			
Cash and balances with			
Reserve Bank of India	6		
Balance with banks and Money at call			
and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11	_____	_____
Total		_____	_____
Contingent liabilities	12		
Bills for collection			

Form 'B'
Form of Profit & Loss Account
for the year ended 31st March

			('000)
	Schedule	Year ended As on 31.3.... (Current year)	Year ended As on 31.3.... (Previous year)
I. Income			
Interest earned	13		
Other income	14		
Total			
II. Expenditure			
Interest expended	15		
Operating expenses	16		
Provisions and contingencies			
Total			
III. Profit/Loss			
Net profit/loss (—) for the year			
Profit/Loss (—) brought forward			
Total			
IV. Appropriations			
Transfer to statutory reserves			
Transfer to other reserves			
Transfer to Government/Proposed dividends			
Balance carried over to balance sheet			
Total			

Schedules forming part of Balance Sheet

Schedule 1 - Capital

As on 31.3... As on 31.3...
 (Current year) (Previous year)

I. For Nationalised Banks

Capital (Fully owned by
 Central Government)

II. For Banks Incorporated outside India**Capital**

(i) (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)

(ii) Amount of deposit kept with the RBI under Section 11(2) of the Banking Regulation Act, 1949

Total

III. For other Banks

Authorised Capital

(____ Shares of ` ____ each)

Issued Capital

(____ Shares of ` ____ each)

Subscribed Capital

(____ Shares of ` ____ each)

Called-up Capital

(____ Shares of ` ____ each)

Less: Calls unpaid

Add: Forfeited shares

Total

Schedule 2 - Reserves and Surplus

As on 31.3.... As on 31.3....
(Current year) (Previous year)

I. Statutory Reserves

Opening Balance

Additions during the year

Deductions during the year

II. Capital Reserves

Opening Balance

Additions during the year
Deductions during the year

III. Share Premium

Opening Balance
Additions during the year
Deductions during the year

IV. Revenue and other Reserves

Opening Balance
Additions during the year
Deductions during the year

V. Balance in Profit and loss Account

Total: (I, II, III, IV and V)

Schedule 3 - Deposits

As on 31.3... As on 31.3...
(Current year) (Previous year)

A. I. Demand Deposits

- (i) From banks
- (ii) From others

II. Savings Bank Deposits

III. Term Deposits

- (i) From Banks
- (ii) From others

Total: (I, II and III)

B. (i) Deposits of branches in India

- (ii) Deposits of branches outside India

Total

Schedule 4 - Borrowings

As on 31.3.... As on 31.3....

(Current year) (Previous year)

I. Borrowings in India

- (i) Reserve Bank of India
- (ii) Other banks
- (iii) Other institutions and agencies

II. Borrowings outside India

Total: (I and II)

Secured borrowings included in I & II above - `

Schedule 5 - Other Liabilities and Provisions

As on 31.3.... As on 31.3....

(Current year) (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.... As on 31.3....

(Current year) (Previous year)

I. Cash in hand (including foreign currency notes)**II. Balances with Reserve Bank of India**

- (i) In Current Account
- (ii) In Other Accounts

Total: (I & II)**Schedule 7 - Balances with Banks & Money at Call & Short Notice**

As on 31.3.... As on 31.3....

(Current year) (Previous year)

I. In India

- (i) Balances with banks
 - (a) in Current Accounts
 - (b) in Other Deposit Accounts
- (ii) Money at call and short notice

- (a) with banks
- (b) with other institutions

Total: (i & ii)

II. Outside India

- (i) In Current Accounts
- (ii) In other Deposits Accounts
- (iii) Money at call and short notice

Total

Grand Total (I & II):

Schedule 8 - Investments

As on 31.3.... As on 31.3....
(Current year) (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.... As on 31.3....
(Current year) (Previous year)

- A. (i) Bills purchased and discounted

- (ii) Cash credits, overdrafts
and loans repayable on demand
- (iii) Term loans

Total

- B. (i) Secured by tangible assets
- (ii) Covered by Bank/Government Guarantees
- (iii) Unsecured

Total

C. I. Advances in India

- (i) Priority Sectors
- (ii) Public Sector
- (iii) Banks
- (iv) Others

Total

II. Advances outside India

- (i) Due from banks
- (ii) Due from others
 - (a) Bills purchased and discounted
 - (b) Syndicated loans
 - (c) Others

Total

Grand Total: (C. I & II)

Schedule 10 - Fixed Assets

As on 31.3.... As on 31.3....
(Current year) (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.... As on 31.3....
(Current year) (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

Schedule 12 - Contingent Liabilities

As on 31.3.... As on 31.3....
(Current year) (Previous year)

I. Claims against the bank not acknowledged as debts
 II. Liability for partially paid investments
 III. Liability on account of outstanding forward exchange contracts
 IV. Guarantees given on behalf of constituents
 (a) In India
 (b) Outside India
 V. Acceptances, endorsements and other obligations
 VI. Other items for which the bank is contingently liable

Total

Schedules forming part of Profit and Loss Account

Schedule 13 - Interest Earned

Year ended Year ended
31.3.... 31.3....
(Current year) (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 Year ended
31.3.... 31.3....
(Current year) (Previous year)

- I. Commission, exchange and brokerage
- II. Profit on sale of investments
 - Less: Loss on sale of investments
- III. Profit on revaluation of investments
 - Less: Loss on revaluation of investments
- IV. Profit on sale of land, building and other assets
 - Less: Loss on sale of land, building and other assets
- V. Profit on exchange transactions
 - Less: Loss on exchange transactions
- VI. Income earned by way of dividends etc. from subsidiaries/companies and/or joint ventures abroad/in India
- VII. Miscellaneous Income
- Total**

Schedule 15 - Interest Expended

Year ended Year ended
31.3.... 31.3....
(Current year) (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	Year ended
	31.3....	31.3....
	(Current year)	(Previous year)
I. Payments to and provisions for employees		
II. Rent, taxes and lighting		
III. Printing and stationery		
IV. Advertisement and publicity		
V. Depreciation on Bank's property		
VI. Director's fees, allowances and expenses		
VII. Auditor's fees and expenses (including branch auditor's fees and expenses)		
VIII. Law Charges		
IX. Postages, Telegrams, Telephones, etc.		
X. Repair and maintenance		
XI. Insurance		
XII. Other expenditure		
Total		

UNIT6: CAPITAL ADEQUACY NORMS

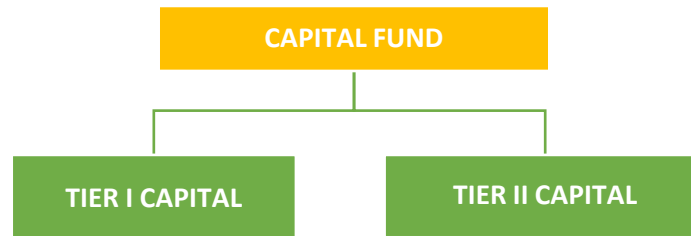
- Capital adequacy is used to describe adequacy of capital resources of a bank in relation to the risks associated with its operations.
- The Basel Committee on Banking Supervision released Basel I, Basel II, Basel III frame works. As per Basel II norms, RBI introduced **capital to Risk Weighted Assets Ratio OR capital adequacy ratio** in India as a capital adequacy measure.
- The main objectives of Basel committee were:
 - to stop reckless lending by bank
 - to strengthen the soundness and stability of the banking system and
 - to have a comparative footing of the banks of different countries.
- Every bank should maintain a minimum capital adequacy ratio based on capital funds and risk assets. As per the prudential norms, all Indian scheduled commercial banks (excluding regional rural banks) as well as foreign banks operating in India are required to maintain capital adequacy ratio which is specified by RBI from time to time. At present capital adequacy ratio is 9%.

5.

The capital adequacy ratio is worked out as below:

$$\frac{\text{Capital fund}^{**}}{\text{Risk weighted assets + off balance sheet items}} \times 100$$

6.



7. Capital is divided into two tiers according to the characteristics/qualities of each qualifying instrument. Tier I capital consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses. Tier II capital on the other hand consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

8. **Tier I capital** (also known as core capital) provides the most permanent and readily available support to a bank against unexpected losses.

The elements of Tier I capital include

- (i) Paid-up capital (ordinary shares), statutory reserves, and other disclosed free reserves, including share premium if any.
- (ii) Perpetual Non-cumulative Preference Shares (PNCPS) eligible for inclusion as Tier I capital - subject to laws in force from time to time.
- (iii) Innovative Perpetual Debt Instruments (IPDI) eligible for inclusion as Tier I capital, and
- (iv) Capital reserves representing surplus arising out of sale proceeds of assets.

As reduced by:

- intangible assets and losses in the current period and those brought forward from previous period.
- DTA, which is an intangible asset

9. **Tier II capital:**

comprises elements that are less permanent in nature or are less readily available than those comprising Tier I capital. The elements comprising Tier II capital are as follows:

- (a) Undisclosed reserves
- (b) Revaluation reserves (it would be prudent to consider revaluation reserves at a discount of 55%)
- (c) General provisions and loss reserves
- (d) Hybrid debt capital instruments
- (e) Subordinated debt
- (f) Investment Reserve Account

10. The quantum of Tier II capital is limited to a maximum of 100% of Tier I Capital.

11. RISK-ADJUSTED ASSETS:

For CAR purposes the entire assets side of the Banks Balance Sheet is recalculated on the basis of assigning risk weights to each category of assets. This follows the principle of conservatism by considering assets at their Risk Adjusted Values rather than at their book value in calculating the CAR

Sr. No.	Item of asset	Risk Weight %
1.	Cash, balances with RBI	0
2.	Balances in current account with other banks	20
3.	Investments in Government Securities	0
4.	Other investments	100
5.	Loans & Advances guaranteed by Government	0
6.	Other Loans & Advances *	100
7.	Bank Premises, Furniture & Fittings etc.	100
8.	All Off- Balance Sheet Items like LC's, LG's, Bills	100
9.	Non funded exposure to Real estate	150

* The risk weight assets depend upon the credit rating, industry etc.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

Given below interest on advances of a commercial bank.

(Rs. in Lakhs)

Particulars	Performing Assets		NPA	
	Interest Earned	Interest Received	Interest Earned	Interest Received
Term Loans	120	80	75	5
Cash credit & OD	750	620	150	12
Bills purchased & discounted	150	150	100	20

Find out the income to be recognized for the year ended 31st March 2012.

(ANS.: TOTAL INCOME TO BE RECOGNIZED: 1057L)

PROBLEM 2:

Find out the income to be recognized in the case of SS Bank for the year ended 31st March, 20X1:

(Rs. in lakhs)				
	Performing Assets		Non-performing Assets	
	Interest accrued	Interest received	Interest accrued	Interest received
Term loans	240	160	150	10
Cash credits and overdrafts	1,500	1,240	300	24

(SM) (TOTAL INTEREST TO BE RECOGNIZED: RS.1,774 LACKS)

PROBLEM 3:

Sanctioned limit Rs. 60,00,000

Drawing power Rs. 55,00,000

Amount outstanding continuously from 1.01.20X1 to 31.03.20X1 Rs. 47,00,000

Total interest debited Rs. 3,42,000

Total credits

Rs.1,25,000

Give your comment , whether above credit facility is NPA or not?

PROBLEM 4:

- 1) The outstanding amount (funded as well as unfunded) as on 31st March, 20X1 was Rs.10,000. The realizable value of security of the same was Rs.8,000.
- 2) Period for which the advance has remained in 'doubtful' category as on 31st March, 20X1 was: 2.5 years.

Show the provisions required for the financial years ended 31 march 20X1 and 31 March 20X2

(SM) (ANS.: TOTAL PROVISION RS. 5,200)

PROBLEM 5:

From the following information, find out the amount of provisions to be shown in the Profit and Loss Account of AG bank.

Assets	Rs. in lakhs
Standard	5000
Sub-standard	4000
Doubtful: for one year	800
: for three years	600
: for more than three years	200
Loss Assets	1000

(SM) (ANS.: TOTAL AMOUNT OF PROVISION - 2260L)

PROBLEM 6:

From the following information of AY Limited, compute the provisions to be made in the Profit and Loss account.

Particulars	Rs. in lakhs
Assets:	
Standard	20,000
Sub standard	16,000
Doubtful	
For one year (secured)	6,000

For two to three years (secured)	4,000
For more than three years (secured by mortgage of plant and machinery of Rs.600 lakhs)	2,000
Loss assets	1,500

(SM) (ANS.: TOTAL AMOUNT OF PROVISION - 9080L)

PROBLEM 7:

Outstanding balance	Rs.4 lakhs
ECGC cover	50%
Period for which the advance has remained doubtful	More than 3 years remained doubtful (as on march 31,20X1)
Value of security held	Rs.1.50 lakhs

You are required to calculate provisions.

PROBLEM 8:

Outstanding balance	Rs.4 lakhs
ECGC cover	50%
Period of which the advance has remained doubtful	More than 3 years remained doubtful (as on march 31, 20X1)
Value of security held (realizable value only 80%)	Rs. 1.50 lakhs

You are required to calculate provisions as per applicable rates.

(SM) (ANS:TOTAL PROVISION: RS.2.75 LAKHS)

PROBLEM 9:

In KR bank the doubtful assets (more than 3 years) as on 31-3-2012 is Rs. 1,000 lakhs. The value security (including DICGC 100% cover of Rs.100 lakhs) is ascertained at Rs.500 lakhs. How much provision must be made in the books of the bank towards doubtful assets?

(SM) (ANS.: TOTAL PROVISION RS. 900L)

PROBLEM 10:

A loan outstanding of Rs 50,00,000 has DICGC cover. The loan guaranteed by DICGC is assigned a risk weight of 50%. What is the value of Risk-adjusted asset?

(SM) (ANS.: VALUE OF RISK-ADJUSTED ASSET – 25L)

PROBLEM 11:

The following is an extract from Trial Balance of overseas Bank as at 31st March, 20X1

Particulars	Debit Rs.	Credit Rs.
Bills discounted	12,64,000	-
Rebate on bills discounted not due on 31 st March, 2012	-	22,160
Discount received		1,05,708

An analysis of the bills discounted is as follows:

Rs.	Due date in 2013	Rate of Discount in % (p.a.)
1,40,000	June 5 th	14
4,36,000	June 12 th	14
2,82,000	June 25 th	14
4,06,000	July 6 th	16

Calculate Rebate on Bills Discounted as on 31-3-20X1 and show necessary journal entries.

(SM) (ANS.: REBATE ON BILLS DISCOUNTED: RS.42,317)

PROBLEM 12:

On 31st March, 20X1, Uncertain Bank had a balance of Rs.9 crores in “rebate on bills discounted” account. During the year ended 31st March, 20X2, Uncertain Bank discounted bills of exchange of Rs. 4,000 crores charging interest at 18% per annum the average period of discount being for 73 days. Of these, bills of exchange of Rs.600 crores were due for realisation from the acceptors/customers after 31st March, 20X2, the average period outstanding after 31st March, 20X2 being 36.5 days.

Uncertain Bank asks you to pass journal entries and show the ledger accounts pertaining to:

- i) Discounting of bills of exchange and
- ii) Rebate on bills discounted.

(SM) (ANS.: TOTAL OF DISCOUNT ON BILLS A/C 153.00, REBATE ON BILLS DISCOUNTED 19.80)

PROBLEM 13:

On 01.04.20X1 Bills for collection were Rs.7,00,000. During 20X1-20X2 bills received for collection amounted to Rs.64,50,000, bills collected were Rs.47,00,000 and bills dishonoured and returned was Rs.5,50,500. Prepare Bills for collection (Assets) A/c and bills for Collection (Liability) A/c.

(SM) (ANS: Bills for collection (Assets) A/c:RS.19 LAKHS, bills for Collection (Liability) A/c:RS.19)

PROBLEM 14:

From the following details prepare “Acceptances, Endorsements and other Obligation A/c” as would in the general ledger. On 1-4-20X1 Acceptances not yet satisfied stood at Rs.22,30,000. Out of which Rs.20 lakhs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register (for transactions during the year) revealed the following:

Client	Acceptances / Guarantees	Remarks
A	10,00,000	Bank honoured on 10-6-20X1
B	12,00,000	Party paid off on 30-9-20X1
C	5,00,000	Party failed to pay and bank had to honour on 30-11-20X1
D	8,00,000	Not satisfied up to 31-3-20X2
E	5,00,000	-DO-
F	2,70,000	-DO-
Total:	42,70,000	

(SM)

PROBLEM 15:

Following facts have been taken out from the records of Adarsha Bank Ltd. in respect of the year ending March 31, 20X2:

1. On 01.04.20X1 Bills for collection were Rs.7,00,000. During 20X1-20X2 bills received for collection amounted to Rs.64,50,000, bills collected were Rs.47,00,000 and bills dishonoured and returned were Rs.5,50,500. Prepare Bills for collection (Assets) A/c and bills for Collection (Liability) A/c.
2. On 01.04.20X1, Acceptance, Endorsement, etc. not yet satisfied amounted to Rs.14,50,000. During the year under question, Acceptances, Endorsements, Guarantees etc., amounted to Rs.44,00,000. Bank honoured acceptances to the extent of Rs.25,00,000 and client paid off Rs.10,00,000 against the guaranteed liability. Clients failed to pay Rs.1,00,000 which the Bank had to pay. Prepare “Acceptances, Endorsements and other Obligations A/c” as it would appear in the General ledger.
3. It is found from the books, that a loan of Rs.6,00,000 was advanced on 30.09.20X1 @ 10 per cent p.a. interest payable half yearly; but the loan was outstanding as on 31.03.20X2 without any payment recorded in the meantime, either towards principal or towards interest. The security for the loan was 10,000 fully paid shares of Rs.100 each (the market value was Rs.98 as per the Stock Exchange Information as on 30th September, 20X1). But due to fluctuations, the price fell to Rs.40 per share in January, 20X2. On 31.03.20X2, the price as per Stock

Exchange rate was Rs.82 per share. State how you would classify the loan as secured / unsecured in the Balance Sheet of the Company.

4. The following balances are extracted from the Trial Balance as on 31.03.20X2:

Particulars	Dr. Rs.	Cr. Rs.
Interest and Discounts		98,00,000
Rebate for bills discounted		20,000
Bills discounted and purchased	4,00,000	

It is ascertained that the proportionate discounts not yet earned for bills to mature in 20X2-20X3 amount to Rs. 14,000. Prepare Ledger Accounts.

(SM)(ANS.: A) TOTAL OF BILLS FOR COLLECTION A/C 71,50,000; B) BALANCE 22,50,000; C) FULLY SECURED; D) TOTAL OF REBATE ON BILLS DISCOUNTED 20,000 AND TOTAL OF INTEREST & DISCOUNT A/C 98,06,000)

PROBLEM 16:

From the following information, prepare Profit and Loss A/c of Dimple Bank as on 31.03.2013:

'000 Rs.	Item	Rs. In 000's
2011-12		2012-13
14,27	Interest and Discount	20,45
1,14	Income from investment	1,12
1,55	Interest on Balance with RBI	1,77
7,22	Commission, Exchange and Brokerage	7,12
12	Profit on sale of investments	1,22
6,12	Interest on Deposits	8,22
1,27	Interest to RBI	1,47
7,27	Payment to and provision for employees	8,55
1,58	Rent, taxes and lighting	1,79
1,47	Printing and stationery	2,12
1,12	Advertisement and publicity	98
98	Depreciation	98

1,48	Director's fees	2,12
1,10	Auditor's fees	1,10
50	Law charges	1,52
48	Postage, telegrams and telephones	62
42	Insurance	52
57	Repairs & maintenance	66

Also give necessary Schedules:

Other Information:

1. The following items are already adjusted with Interest and Discount (Cr.):

Tax Provision ('000 Rs.)	1,48
Provision for Doubtful Debts ('000 Rs.)	92
Loss on sale of Investments ('000 Rs.)	12
Rebate on Bills discounted ('000 Rs.)	55

2. Appropriations:

25% of profit is transferred to Statutory Reserve.

5% of profit is transferred to Revenue Reserve.

(SM)(ANS.: BALANCE IN PROFIT & LOSS ACCOUNT CARRIED TO BALANCE SHEET -RS. 66,100)

PROBLEM 17:

From the following information, prepare Profit and Loss A/c of KC Bank for the year ended 31st March, 2013.

Items	Rs. (in '000)
Interest on cash credit	18,20
Interest on overdraft	7,50
Interest on term loans	15,40
Interest on investments	8,40
Interest on balance with RBI	1,50
Commission on remittances and transfer	75

Commission on letters of credit	1,18
Commission on government business	82
Profit on sale of land and building	27
Loss on exchange transactions	52
Interest paid on deposit	27,20
Auditors' fees and allowance	1,20
Directors' fees and allowances	2,50
Advertisements	1,80
Salaries, allowances and bonus to employees	12,40
Payment to Provident Fund	2,80
Printing and stationery	1,40
Repairs and maintenance	50
Postage, telegrams, telephones	80

Other Information:

1. Interest on NPA is as follows:

Particulars	Earned (Rs.'000)	Collected (Rs.'000)
Cash credit	8,20	4,00
Overdraft	450	1,00
Term Loans	750	2,50

2. Classification of non performing advances

(‘000 Rs.)

Standard	30,00
Sub-standard	11,20
Doubtful assets not covered by security	2,00
Doubtful assets covered by security for one year	50
Loss Assets	2,00

3. Investments

27,50

Bank should not keep more than 25% of its investments as 'held-for-maturity' investments. The market value of its rest 75% investments is Rs.19,75,000 as on 31.03.2013.

(SM) (ANS.: BALANCE IN PROFIT & LOSS ACCOUNT- (16,60,000))

PROBLEM 18:

From the following information, prepare a Balance Sheet of ADT International Bank as on 31st March, 20X1 giving the relevant schedules.

Rs. in lakhs		
Particulars	Dr.	Cr.
Share Capital:		
19,80,000 Shares of Rs.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 of collection	18,10,000
---------------------	-----------

Acceptances and endorsements	14,12,000
Claims against the Bank not acknowledged as debts	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 (including debit balance in current A/C) is unsecured. Transfer 25% of its profit to the reserve fund.

(SM) (ANS.: TOTAL OF BALANCE SHEET - 25,88.22L)

PROBLEM 19:

A commercial bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capitals. Find out the capital to risk weighted assets ratio:

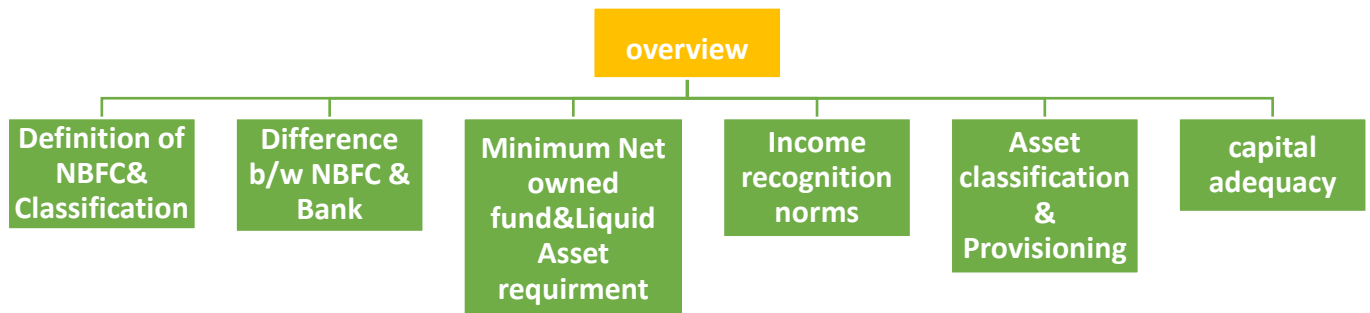
Capital Funds	(Figures in Rs. lakhs)
Equity Share Capital	4,80,00
Statutory Reserve	2,80,00
Capital Reserve (of which Rs. 280 lakhs were due to revaluation of assets and the balance due to sale)	12,10
Assets:	
Cash Balance with RBI	4,80
Balances with other Bank	12,50
Claims on Banks	28,50
Other Investments	782,50
Loans and Advances:	
(i) Guaranteed by government	128,20
(ii) Guaranteed by public sector undertakings of Government of India	702,10
(iii) Others	52,02,50
Premises, furniture and fixtures	182,00
Other Assets	201,20

Off-Balance Sheet Items: Acceptances, endorsements and letters of credit	37,02,50
--	----------

(SM) (ANS.: CAPITAL ADEQUACY RATIO - 7.65%)

CA SATYA RAJU

12. NON-BANKING FINANCIAL COMPANIES



INTRODUCTION:

Non-Banking Financial Companies (NBFC) play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognized as complementary to the banking system.

DEFINITION OF NBFC:

A Non-Banking Financial Company (NBFC) (As per Reserve Bank of India (RBI) FAQ)

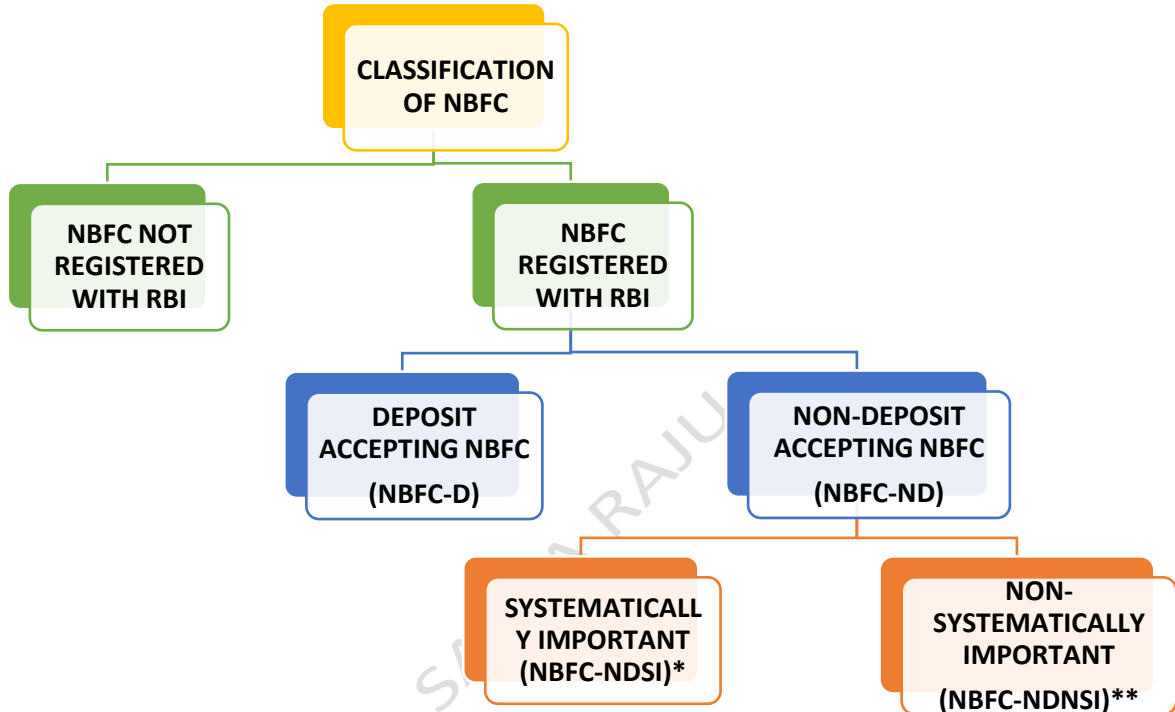
- is a company registered under the Companies Act, 1956 or 2013;
 - engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of like nature, leasing, hire-purchase, insurance business, chit business;
 - but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.
- A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

REGISTRATION:

1. In terms of Section 45-IA of the RBI Act, 1934, no NBFC shall commence or carry on business of a non-banking financial institution without
 - a) obtaining a certificate of registration from the Reserve Bank of India (RBI); and
 - b) having Net Owned Funds (NOF) of ₹ 200 lakhs.
2. They can apply to the RBI in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

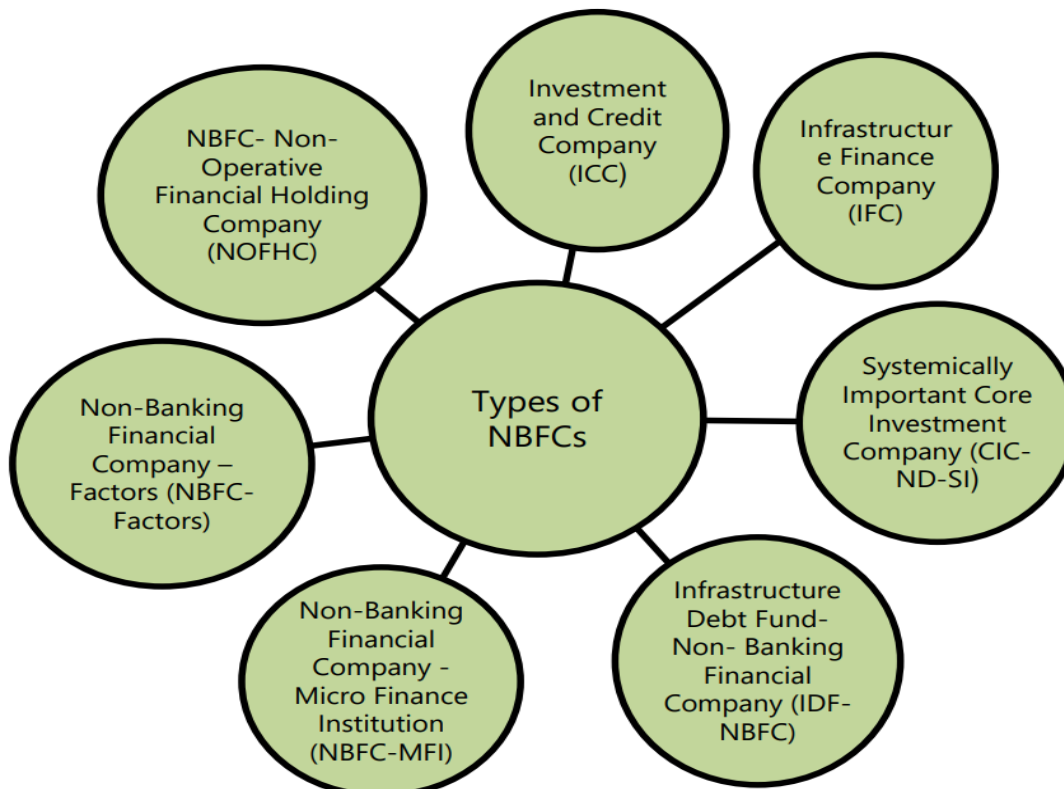
3. However, in terms of the powers given to the RBI, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI

CLASSIFICATION OF NBFC:

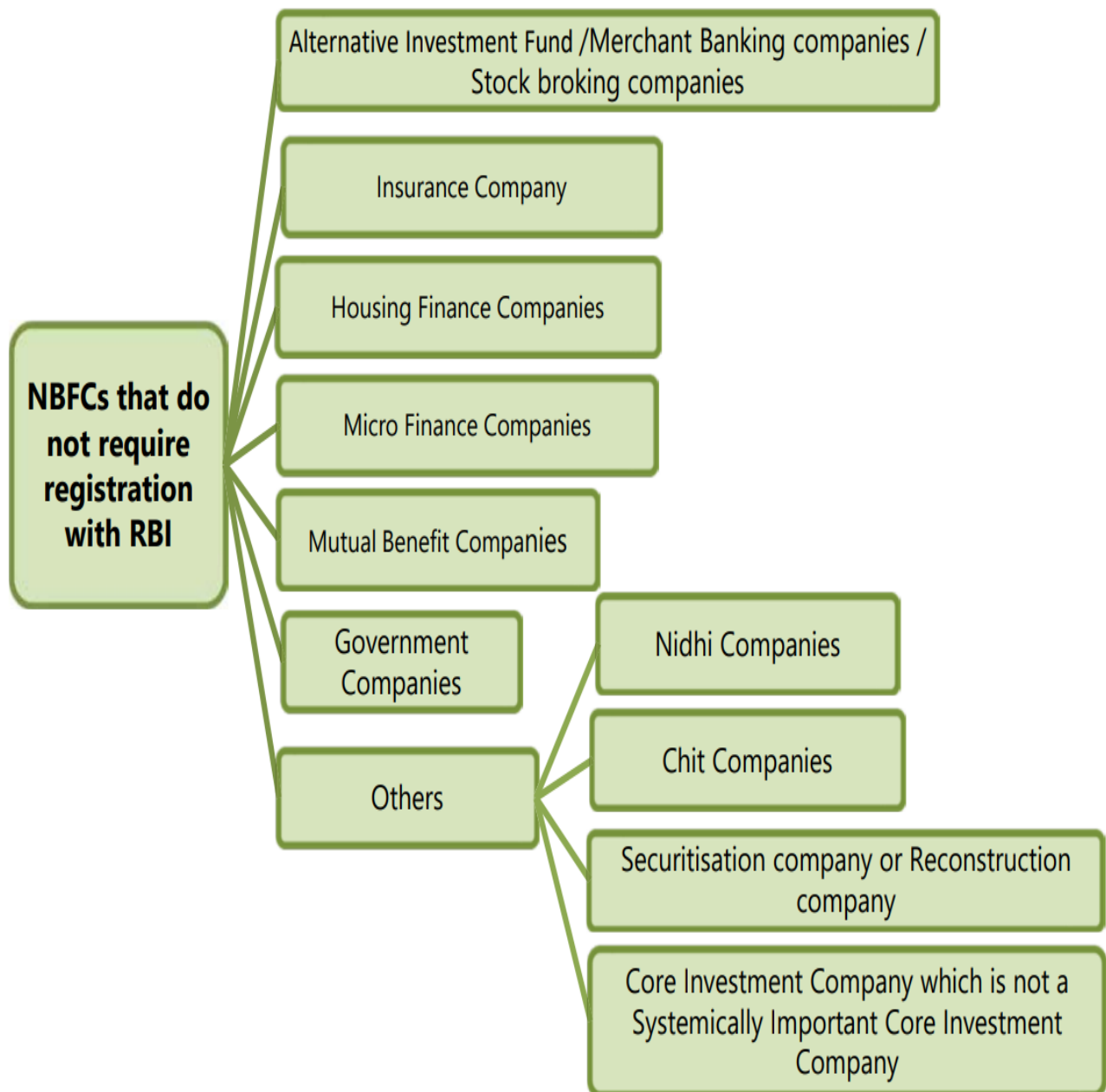


* those with asset size of ₹500 crs or more. ** those with asset size of ₹500 crs or more.

NBFCs registered with RBI are classified under following categories (By the kind of activities they conduct):



NBFCs not registered with RBI are classified under following categories:



MINIMUM NET OWNED FUND:

1. On registration of NBFC with the RBI, all NBFCs have to comply with certain requirements like maintenance of the minimum Net Owned Fund (NOF), creation of reserve fund, compulsory transfer of certain percentage of net profit etc.
2. NOF requirement for new companies applying for grant of CoR to commence business of an NBFC is stipulated at ` 2 crores.

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC – Book value of debentures, bonds, outstanding loans and advances including hire purchase and lease finance

made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund).

Owned Fund = Aggregate of the paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, after deducting therefrom accumulated balance of loss, book value of intangible assets and other deferred revenue expenditure, if any.

LIQUID ASSET REQUIREMENTS:

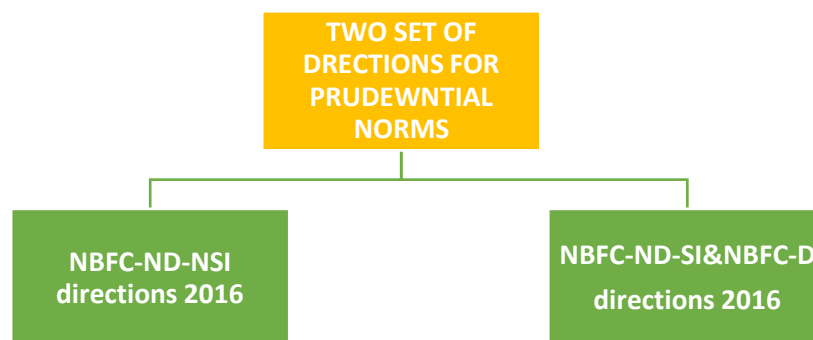
1. In terms of Section 45-IB of the RBI Act, 1934 the minimum level of liquid asset to be maintained by NBFCs is 15 per cent of public deposits outstanding as on the last working day of the second preceding quarter.
2. Of the 15%, NBFCs are required to invest not less than 10% in approved securities and the remaining 5% can be in unencumbered term deposits with any scheduled commercial bank.
3. Thus, the liquid assets may consist of government securities, government guaranteed bonds and term deposits with any scheduled commercial bank.

PRUDENTIAL NORMS:

In order to ensure that NBFCs function on sound and healthy lines and make adequate disclosures in their financial reports, the Reserve Bank has issued prudential norms for all the Non-banking Financial Companies.

- a) Norms relating to Income Recognition, Asset Classification and Provisioning norms;
- b) Capital to Risk Weighted Assets Ratio (CRAR); and
- c) Credit Concentration Norms

Note: Above mentioned norms in points (b) and (c) are applicable to only NBFCs– D and NBFCs-ND-SI



INCOME RECOGNITION:

1. The income recognition on performing assets shall be based on recognised accounting principles.(As per accounting standards)

Ex: income from dividend on shares of corporate bodies shall be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the applicable NBFC's right to receive payment is established.

2. Income including interest/ discount or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

ASSET CLASSIFICATION:

(a) **Standard asset** means an asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business.

(b) Sub-standard asset:

- i) an asset which has been classified as non-performing asset for a period not exceeding 12 months; [NBFC-ND-SI&NBFC-D directions 2016]
- ii) an asset which has been classified as non-performing asset for a period not exceeding 18 months; [NBFC-ND-NSI directions 2016]

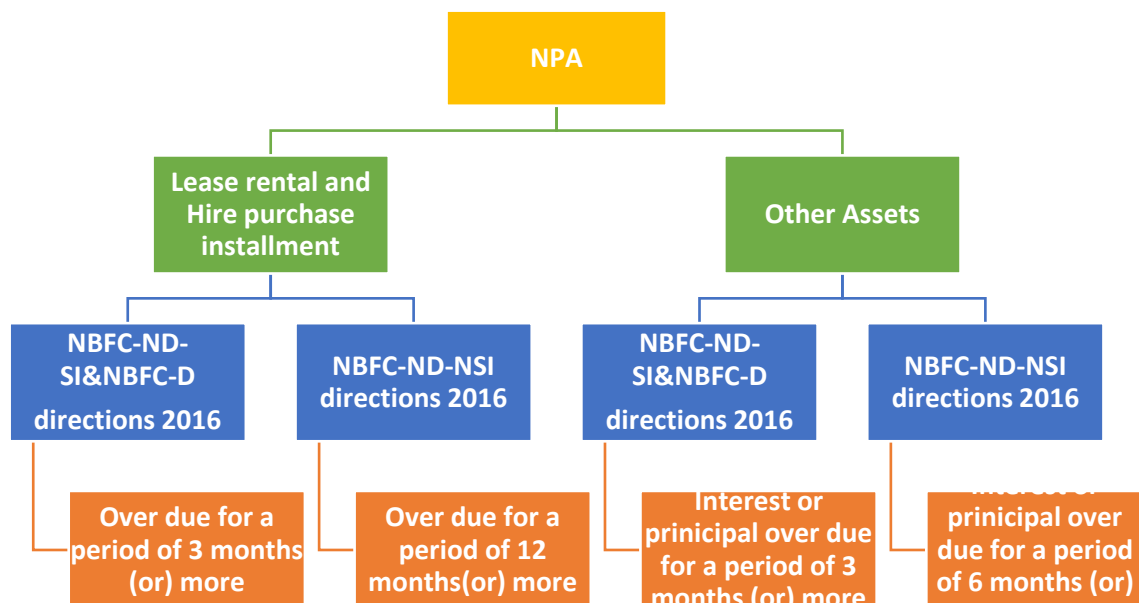
(c) Doubtful asset:

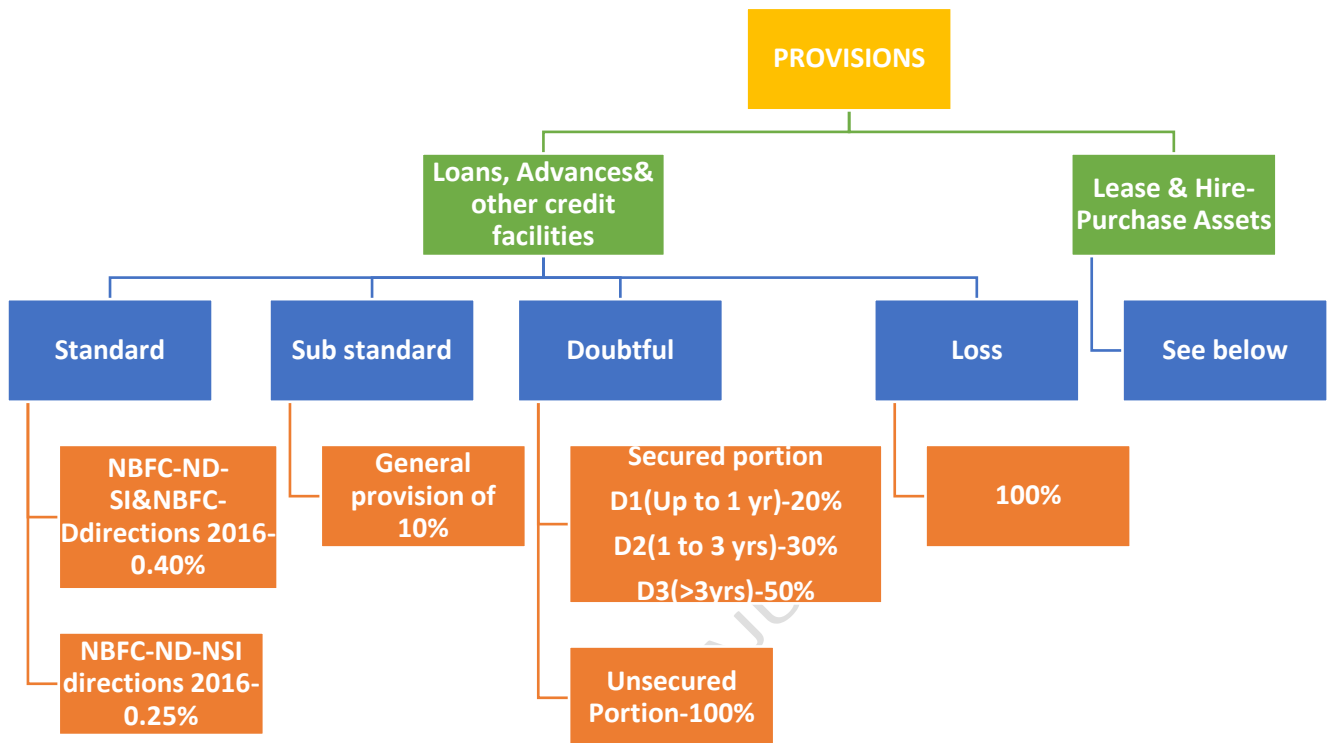
- i) (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding 12 months. [NBFC-ND-SI&NBFC-D directions 2016]
- ii) (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding 18 months. [NBFC-ND-NSI directions 2016]

(d) Loss asset means

- (i) an asset which has been identified as loss asset by the NBFC or its internal or external auditor or by the Reserve Bank during the inspection of the NBFC, to the extent it is not written off by the NBFC; and
- (ii) an asset which is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

Definition of NPA:



PROVISIONING REQUIREMENTS:**Provision on Lease & Hire purchase Assets:**

- (i) In respect of hire purchase assets, the total dues (overdue and future instalments taken together) as reduced by
- (a) the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and
- (b) the depreciated value of the underlying asset,
- shall be provided for.

Explanation:

- the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and
- in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets:

(a) Where hire charges or lease rentals are overdue upto 12 months	Nil
(b) where hire charges or lease rentals are overdue for more than 12 months but up to 24 months	10 percent of the net book value
(c) where hire charges or lease rentals are overdue for more than 24 months but up to 36 months	40 percent of the net book value
(d) where hire charges or lease rentals are overdue for more than 36 months but up to 48 months	70 percent of the net book value
(e) where hire charges or lease rentals are overdue for more than 48months	100 percent of the net book value

'Net book value' means

(a) in the case of hire purchase asset, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 13(2) of these Directions;

(b) in the case of leased asset, aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

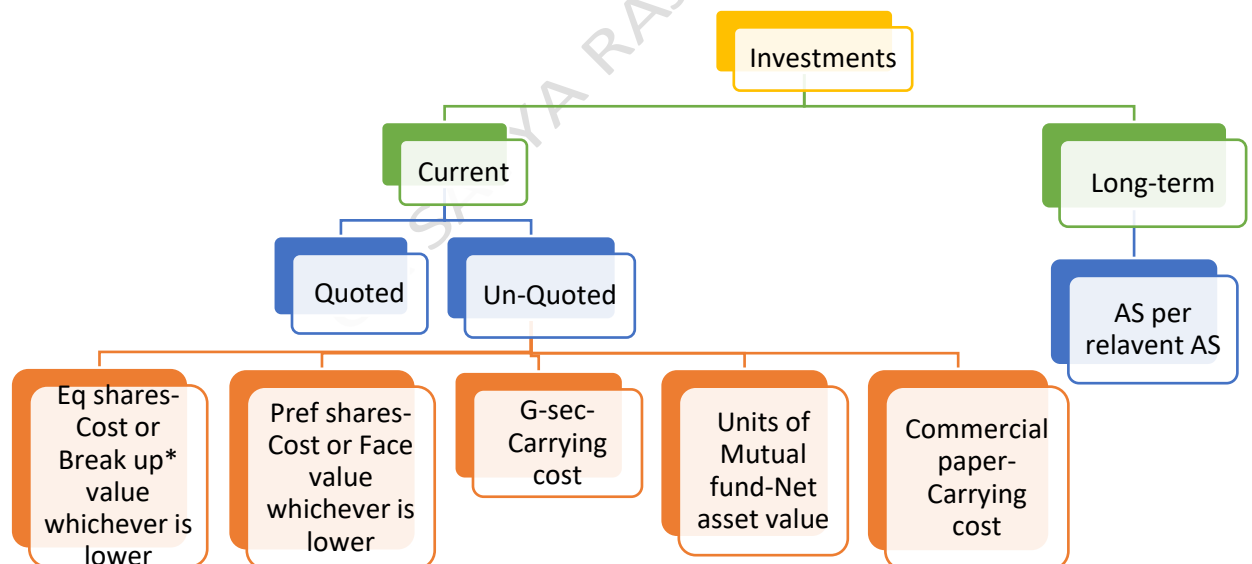
REQUIREMENT AS TO CAPITAL ADEQUACY:

At present, all NB0FCs-D and NBFCs-ND-SI are required to have minimum CRAR of 15%.

ACCOUNTING FOR INVESTMENTS:

1. Investments in securities shall be classified into current and long term, at the time of making each investment;

2.



***Break-up value** means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company.

3. Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

- (a) equity shares,
- (b) preference shares,
- (c) debentures and bonds,
- (d) Government securities including treasury bills,
- (e) units of mutual fund, and
- (f) others.

- i) Quoted current investments for each category shall be valued at cost or market value whichever is lower.
- ii) For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category.
- iii) If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored.
- iv) Depreciation in one category of investments shall not be set off against appreciation in another category.

4. In case of inter class transfer:

- (i) There shall be no such transfer on ad-hoc basis;
- (ii) Such transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;
- (iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;
- (iv) The depreciation, if any, in each scrip shall be fully provided for and appreciation, if any, shall be ignored;
- (v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

PREPARATION OF FINANCIAL STATEMENTS OF NBFCs:

1. All NBFCs should comply with the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India, so far as these are not inconsistent with the directions of the Reserve Bank of India.
2. On 30th March, 2016 the Ministry of Corporate Affairs of India (MCA) issued the roadmap for implementation of Ind AS by Non-Banking Financial Companies.

PROBLEMS FOR DISCUSSION

PROBLEM 1:

Calculate 'owned fund' of a NBFC based on the following facts:

Paid up share capital: Rs.150 lakhs

Free reserves: Rs.250 lakhs.

Compulsory convertible preference shares (CCPS): Rs.50 lakhs

Revaluation reserve : Rs.95 lakhs

(SM) (ANS: TOTAL: Rs.450 lakhs (owned fund))

PROBLEM 2:

Templeton Finance Ltd. is a non-banking finance company. The extracts of its balance sheet are given below:

Liabilities	Amount. Rs'000	Assets	Amount. Rs'000
Paid-up equity capital	100	Leased out assets	800
Free reserves	500	Investment:	
Loans	400	In shares of subsidiaries and group companies	100
Deposits	400	In debentures of subsidiaries and group Companies	100
		Cash and bank balances	200
		Deferred expenditure	200
	1,400		1,400

You are required to compute Net owned Fund of Templeton Finance Ltd. as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(SM)(ANS.: NET OWNED FUND RS'000 – 240)

PROBLEM 3:

Bright Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, Rs.200 lakhs of which instalments are overdue on 200 accounts for last one month (amount overdue Rs. 40 lakhs), on 24 accounts for three months (amount overdue Rs.24 lakhs), on 10 accounts for more than 30 months (amount overdue Rs.20 lakhs) and on 4 accounts for more than two years (amount overdue Rs.20 lakhs-already identified as sub-standard assets) and one account of Rs. 10 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount Rs.6 lakhs) for more than twelve months and other are identified as sub-standard asset for a period of less than twelve months.

Classify the assets of the company in line with Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.
(SM) (ANS: TOTAL OVER DUE:Rs.200 LAKHS)

PROBLEM 4:

While closing its books of account on 31st March, 2018 a Non-Banking Finance Company has its advances classified as follows:

	Rs. in lakhs
Standard assets	16,800
Sub-standard assets	1,340
Secured portions of doubtful debts:	
–upto one year	320
–one year to three years	90
–more than three years	30
Unsecured portions of doubtful debts	97
Loss assets	48

Calculate the amount of provision, which must be made against the Advances as per The Non-Banking Financial Company – Non-Systemically Important Non- Deposit taking Company (Reserve Bank) Directions, 2016;

and also calculate the amount of provision, which must be made against the Advances as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(SM)(ANS.: PROVISION TO BE MADE – FOR NON-SYSTEMATICALLY IMPORTANT - RS.IN LAKHS – 427.00; FOR SYSTEMATICALLY IMPORTANT - RS.IN LAKHS – 443.80)

PROBLEM 5:

Babu Bhai Financiers Ltd. is an NBFC providing Hire Purchase Solutions for acquiring consumer durables the following information is extracted from its books for the year ended 31st March, 20X1:

Assets Funded	Interest Overdue but recognized in Profit & Loss		Net Book value of Assets Outstanding
	Period Overdue	Interest Amount	
		(RS.in Crore)	(RS.in Crore)
LCD televisions	Up to 12 Months	500.00	20,000
Washing Machines	For 24 Months	100.00	2,000
Refrigerators	For 30 Months	50.00	1,250
Air Conditioners	For 45 Months	25.00	600
Mobile Phones	For 60 Months	10.00	100

You are required to calculate the amount of provision to be made.

(SM) (AMOUNT OF PROVISION: 1220 CRORES)

PROBLEM 6:

XYZ limited is an NBFC registered with RBI as non-deposit accepting company. Its main activity includes issuing term loans of different tenures. One of its major customers, ABC Ltd., is engaged in the business of manufacturing. However, due to fall in demand and non-recovery of existing trade receivables. As on 31st march, 20X1 outstanding amount in respect to ABC Ltd. is as under:

Principle amount outstanding (for more than 8 months): Rs.250 lakhs

Interest and penalties on the above: Rs.30 lakhs

XYZ Ltd. is following accrual system for accounting of its income. Following the same, the company has accrued Rs.30 lakhs as interest income in the financial statements for the year ended 31st march, 20X1.

You are required to state whether income accrual of Rs.30 lakhs is in accordance with Non Banking finance company – systemically important non deposit taking company directors, 2016? **(SM)**

NOTES

CA SATYA RAJU