Corporate Accounting

DEACC210

Edited by:
Dr. Nancy

LOVELY PROFESSIONAL UNIVERSITY

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Content

Unit 01: Accounting for Share Capital

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Objectives

After studying this unit, you will be able to:

- explain the fundamental nature of a joint stock company as a type of business organization and the various types of companies based on the liability of their members.
- identify the categories of shares issued by a corporation;
- explain the accounting treatment of shares issued at par, at premium, and at discount, including oversubscription

Introduction

Company or corporate form of organization is the third step in the growth of organizational forms. Its capital is contributed by a huge number of people known as shareholders, who are the company's true owners. However, it is not practicable or desirable for all of them to participate in company management. As a result, they elect a Board of Directors to oversee the company's operations as their representative. In fact, the requirements of the Companies Act of 1956 control all aspects of the company's operations. A corporation is one that was formed or registered under the Companies Act of 1956 or any earlier Companies Act. Chief Justice Marshal defines a firm as "an artificial, invisible, intangible person."

1.1 Features of a Company

The various characteristics of company are as follows-

- Body Corporate: A business is founded in accordance with the norms of current law, except in the instance of banking corporations in India and insurance businesses are founded and registered under Companies Law.

- Separate Legal Entity: A firm has its own legal entity, unique and distinct from its members It can hold and handle any kind of property. It has the ability to enter into contracts and even open a bank account.
- Limited Liability: The company's members' liability is limited to the extent of the unpaid amount of the shares they own. In the instance of the corporations whose liability is limited by guarantee and that too in case of dissolution of the company.
- Perpetual Succession: The business is an artificial person constituted by law, it continues to exist regardless of changes in its membership. Only by law may a company be dissolved. The death, insanity, or insolvency of any company member has no bearing on the business's existence. Members may come and go, but the business remains.
- Common Seal: The Company is an artificial person; it cannot sign its own name. As a result, each corporation is needed to have its own seal, which serves as the company's official signature. Any document that does not bear the firm's common seal is not binding on the company.
- Share Transferability: A public limited company's shares are freely transferable. The authorization of the company or the consent of any of its members is not required for the transfer of shares. However, the company's Articles of Association might specify how shares will be transferred.
- Can sue or be sued: As a legal entity, a company can enter into contracts and enforce contractual rights against others. If the firm breaches the contract, it can sue and be sued in its name.

1.2 Company Types

Companies are classed based on either the liability of their members or the number of members. On the basis of liabilities its members', it can be divided into three categories:

(i) Companies Restricted by Shares: In this instance, the members' responsibility is limited to the nominal value of the shares they own. If a member has paid the whole price of the shares, he has no accountability for the company's debts. He is not required to pay a single penny from his personal property. However, if there is any liability, it can be pursued both during the company's existence and during its dissolution.

(ii) Companies Restricted by Guarantee: In this scenario, the members' liability is limited to the sum they agree to contribute in the event the business is wound up. As a result, the members' liability will occur only in case of winding up.

(iii) Unlimited Companies: An unlimited company is one that has no restriction on the liabilities of its members. When the company's assets are insufficient to pay off its debts, the private property of its members can be used. In other words, creditors can seek payment from its members. Despite being permitted by the Corporations Act of 1956, such companies do not exist in India.

Companies are classified into two categories based on the number of members:

(i) Public Company: A public company is one that is not a privately owned company, has a minimum paid-up capital of Rs. 5 lakh rupees or a greater paid-up capital as defined, and it is not a subsidiary of a private company.

(ii) Private Company: A private company is one that has a minimum paid-up capital of Rs. 1 lakh rupees or a greater paid-up share capital as defined by its articles:

(a) restricts the power to transfer its shares;

(b) limits the number of its members to 50 (excluding its employees); and

(c) bans any public solicitation to subscribe for the company's shares or debentures.

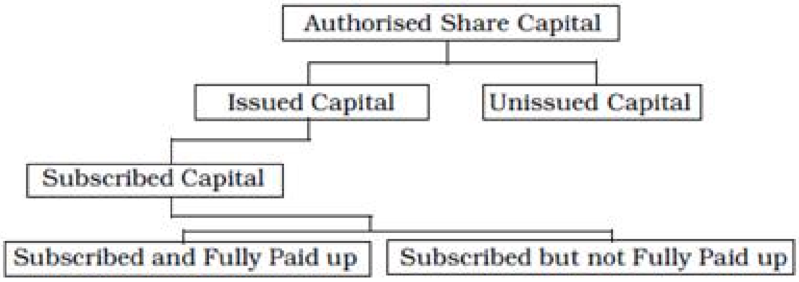
(d) forbids inviting or accepting deposits from anybody other than its members, directors, and family.

1.3 Company's Share Capital

The company's share capital can be categorised as follows in accounting terms:

- Authorised Capital: The proportion of share capital that a company is permitted to issue under its Memorandum of Association. The corporation cannot raise more capital than the amount indicated in the Memorandum of Association. It is also known as nominal capital or registered capital. It can be increased or decreased in accordance with the procedures outlined in the Companies Act. It should be emphasised that the firm does not have to offer the entire authorised capital to the public at once. It may issue share capital depending on its needs, but it should not exceed the amount of authorised capital.
- Issued Capital: This is the portion of the authorised capital that has been issued to the public for subscription, including the shares assigned to suppliers and signatories to the company's memorandum. Unissued capital is authorised capital that is not available for public subscription. Unissued capital may be made available for public subscription at a later time.
- Subscribed Capital: This is the portion of the issued capital that has been subscribed to by the general public. When the public fully subscribes to the shares offered for public subscription, the issued capital and subscribed capital are the same. It should be noted that the subscribed capital and issued capital are ultimately the same because if the number of shares subscribed is fewer than the number of shares offered, the firm only allots the number of shares for which a subscription has been received. If it is greater than the offer, the allocation will be equal to the offer.
- Called up Capital: It is that portion of the subscribed capital that has been called up on the shares. The firm may opt to call all or a portion of the face value of the shares. For example, if the face value (also known as nominal value) of a share is Rs. 20 and the company has only called up Rs. 15 per share, the called up capital is Rs. 15 per share. The remaining Rs. 5 could be collected from the company's shareholders if needed.
- Paid up Capital: It is that portion of the called up capital that has been received from shareholders. When all of the call amount has been paid by the shareholders, the called up capital equals the paid up capital. If any of the stockholders has not paid an amount on calls, that sum is known as 'calls in arrears.' As a result, paid up capital equals called-up capital minus call in arrears.
- Uncalled Capital: The portion of subscribed capital that has yet to be called up. As previously stated, the corporation may collect this payment if it requires additional funds.
- Reserve Capital: A corporation may set aside a portion of its uncalled capital as reserve capital, to be called solely in the event of the company's dissolution. This uncalled-for sum is referred to as the company's "Reserve Capital." It is only provided to creditors in the event of the company's liquidation.

Categories of Share Capital



Let's look at an example to see how the share capital is represented on the balance sheet. Sunrise Company Ltd., New Delhi, has registered a capital of Rs. 40,00,000, divided into 4,00,000 Rs. 10 shares. The firm invited the public to subscribe for 2,00,000 shares of Rs. 10 each in the following increments: Rs. 2 on application, Rs. 3 on allotment, Rs. 3 on first call, and the remainder on final call. The company received 2,50,000 share applications. The corporation completed the allotment of 200,000 shares and rejected 50,000 share applications. The final decision was not made by the firm. Except for 2,000 shares whose call money was not paid, the corporation received the entire amount. The amounts listed above will be displayed as

Share Capital		*(Rs.)*
Authorised or Registered or Nominal Capital:		
4,00,000 Shares of Rs. 10 each		40,00,000
Issued Capital		
2,00,000 Shares of Rs. 10 each		20,00,000
Subscribed Capital		
Subscribed but not fully paid up		
2,00,000 Shares of Rs. 10 each, Rs. 8 called up	16,00,000	
Less : Calls in Arrears	(6,000)	15,94,000

1.4 Share Types & Classes

Shares are the units into which a company's total share capital is divided. Thus, a share is a portion of a company's share capital and serves as the basis for ownership interest. Shareholders are those who contribute money in the form of shares.

The amount of authorised capital, as well as the number of shares for which it is divided, is stated in the Memorandum of Association, but the classes of shares into which the company's capital is to be divided, as well as their corresponding rights and obligations, are prescribed by the company's Articles of Association. A corporation can issue two types of shares under Section 86 of the Companies Act: (1) preference shares and (2) common shares.

Preference Shareholder

A preference share is one that meets the following characteristics, according to Section 85 of The Companies Act of 1956:

(a) That it bears a preferential right to dividends, which are paid either as a fixed sum or as an amount computed by a fixed rate of the nominal value of each share prior to any dividend being paid to equity owners.

(b) That, with respect to capital, it contains or will carry the preferred right to capital repayment before anything is paid to equity shareholders upon the company's dissolution.

Regardless of the above two qualifications, a holder of the these shares may have a chance to participate totally or partially in the company's surpluses as stipulated in the company's Memorandum or Articles. As a result, preference shares might be both participating and non-participating. These shares might also be cumulative or non-cumulative, redeemable or irredeemable.

Equity share capital

An equity share is one that is not a preference share, according to Section 85 of the Companies Act of 1956. In other words, equity/ordinary shares are shares that do not have a preferential entitlement to dividend payment or capital return. After satisfying the dividend rights of the preferential share holders, the equity stockholders are entitled to a part of the company's distributable profits. The dividend on equity capital is not fixed and may fluctuate from year to year based on the amount of profits available for distribution. The equity share capital may be (i) with voting rights; or (ii) with differential voting, dividend, or other rights in accordance with such regulations and subject to such conditions.

1.5 Issue of Shares

A distinguishing feature of a company's capital is that the amount on its shares can be systematically gathered in easy installments spaced over time depending on its expanding financial requirements. The first installment is received with the application and is hence referred to as application money, the second on allotment (referred to as allotment money), and the other instalments are referred to as first call, second call, and so on. The word final is applied to the final instalment. This, however, does not preclude a firm from calling the whole amount on shares at the time of application.

The following are the critical steps in the share issuance procedure:

a. Prospectus Distribution: The prospectus is distributed to the general public initially. A prospectus is an announcement to the public that a new company has been formed and that it requires cash to operate. It offers detailed information on the company and how money will be collected from prospective investors.
b. Application Receipt: When a prospectus is made available to the public, potential investors who wish to subscribe to the company's share capital would submit an application together with the application fee and deposit it with a bank listed in the prospectus. The company must receive a minimum subscription within 120 days of the issue date. If the firm does not receive it within the specified time frame, it will be unable to continue with the allotment of shares, and the application fee will be refunded within 130 days of the prospectus's release date.
c. Share Allotment: If the minimum subscription is collected, the firm may continue with the share allotment after completing certain other legal procedures. Letters of allotment would be sent to individuals who have received shares, and letters of disappointment are sent to those who have not received shares. When an allocation is completed, it creates a legally binding contract between the firm and the applicants, who are now the company's shareholders. A company's shares are issued at par, at a premium, or at a discount.

According to the terms and conditions of issue, shares are to be issued at par when their issue price is exactly equal to their nominal value. When a company's shares are issued for more than their nominal value (face value), the excess amount is known as premium. Shares issued at a discount are those that are issued at a price less than the face value of the share. Regardless of whether shares are issued at par, premium, or discount, a company's share capital, as previously stated, may be recovered through instalments payable at different phases.

1.6 Accounting Methodology

On application: The amount paid in multiple instalments constitutes the contributions to share capital and should be credited to share capital account eventually. However, for the benefit of convenience, individual accounts are originally formed for each instalment. All money obtained with the application is put in a separate account registered with a scheduled bank.

The following is the journal entry:

Bank A/s Dr

To Share Application A/c

(Amount received on application of shares)

When the minimum subscription is collected and certain legal procedures on the allotment of shares have been completed, the company's directors will start to make the allotment of shares.The issuance of shares involves a contract between the company and the applicants, who are now the allottees and have the status of stockholders.The following are the journal entries for share allotment:

For Transfer of Application Money
Share Application A/c Dr.
To Share Capital A/c
(Application money on Shares transferred to Share Capital)
For Money Refunded on Rejected Application
Share Application A/c Dr.
To Bank A/c
(Application money returned on rejected application)
For Amount Due on Allotment
Share Allotment A/c Dr.
To Share Capital A/c
For Adjustment of Excess Application Money
Share Application A/c Dr.
To Share Allotment A/c
(Application Money on Shares adjusted to the amount due on allotment).
For Receipt of Allotment Money
Bank A/c Dr.
To Share Allotment A/c
(Allotment money received on shares)

On Calls: Calls are essential for fully paid up shares and realising the full money from shareholders. If shares are not fully called up by the end of the allocation period, the directors have the authority to request the remaining amount on shares as and when they see appropriate. It is also likely that the timing of call payments by shareholders is decided at the time issue of shares and is disclosed in the prospectus.Two points are critical when it comes call on shares. To begin, the amount on any call should not exceed 25% of the face value of the shares. Second, unless otherwise stipulated by the company's articles of association, there must be a one-month delay between two calls.

When a call is made and the money is received, the journal entries are as follows:

For Call Amount Due

Share Call A/c Dr.

To Share Capital A/c

(Call money due on Shares)

For Receipt of Call Amount

Bank A/c Dr.

To Share Call A/c

(Call money received)

Depending on the identification of the call, the word/words First, Second, or Third must be put between the words "Share" and "Call" in the Share Call account. For example, in the event of the first call, it will be referred to as 'Share First Call Account,' in the case of the second call, 'Share Second Call Account,' and so on.

Example- Mona Earth Mover Limited has agreed to issue 12,000 shares of Rs.100 each, payable at Rs.30 on application, Rs.40 on allotment, Rs.20 on first call, and the remainder on second and final calls. For 13,000 shares, applications were received.The directors decided to reject the application for 1,000 shares and refund the application fee in full. Except for 100 shares, allotment money was received on all shares, and all payments due on calls were received. Enter the transactions into Mona Earth Movers Limited's books.

Solution-In the books of Mona Earth Mover Limited

Bank A/c Dr. 3,90,000

To Share Application A/c 3,90,000

(Application money on 13,000 shares @ Rs.30 per share received)

Share Application A/c Dr. 3,60,000

To Share Capital A/c 3,60,000

(Application money transferred to share capital)

Share Application A/c Dr. 30,000

To Bank A/c 30,000

(Application money on 1,000 shares returned]

Share Allotment A/c Dr. 4,80,000

To Share Capital A/c 4,80,000

(Money due on allotment of 12,000 shares @ Rs. 40 per share)

Bank A/c Dr. 4,80,000

To Share Allotment A/c 4,80,000

(Money received on 12,000 shares @ Rs. 40 per share on allotment)

Share First Call A/c Dr. 2,40,000

To Share Capital A/c 2,40,000

(Money due on 12,000 shares @ Rs. 20 per share on first Call)

Bank A/c Dr. 2,38,000

To Share First Call A/c 2,38,000

(First Call money received except for 100 shares)

Share Second and Final Call A/c Dr. 1,20,000

To Share Capital A/c 1,20,000

(Money due on 12,000 shares @ Rs. 10 per share on Second and final Call)

Bank A/c Dr. 1,19,000

To Share Second and Final Call A/c 1,19,000

(Second and final call money received except for 100 shares)

Overdue Calls

It is possible that shareholders will fail to pay the call amount by the due date. When he fails to pay the sum due on allotment or any of the calls, the amount is referred to as 'Calls in Arrears'/'Unpaid Calls.' Calls in Arrears is the debit balance of the entire calls account. This sum will appear as a 'Note to Accounts'. However, if a corporation keeps a 'Calls in Arrears' Account, the following additional journal entry must be made:

Calls in Arrears A/c Dr.

To Share First Call Account A/c

To Share Second and Final Call A/c

(Calls in arrears brought into A/c)

Sometimes shareholders pay a part or the whole of the amount of the calls not yet made. The amount so received from the shareholders is known as "Calls in Advance". The amount received in advance is a liability of the company and should be credited to 'Call in Advance Account." The amount received will be adjusted towards the payment of calls as and when they becomes due. Table A of the Companies Act provides for the payment of interest on calls in advance at a rate not exceeding 6% per annum.

The following journal entry is recorded for the amount of calls received in advance.

Bank A/c Dr.

To Calls in Advance A/c

(Amount received on call in advance)

On the due date of the calls, the amount of 'Calls in Advance' is adjusted by thefollowing entry :

Calls in Advance A/c Dr.

To Particular Call A/c

(Calls in advance adjusted with the call money due)

Subscription Excess/Over Subscription

There are times when more applications for a company's shares are received than the volume of shares available for subscription to the general public. This is known as 'Over Subscription' and occurs in the case of shares issued by well-managed and financially sound companies.In such a case, the directors have three options for dealing with the situation: (1) accept certain applications in full and reject the rest; (2) make a pro-rata allotment to everyone; or (3) combine the above two options, which is the most typical course of action in practise.

The issue of oversubscription is settled by the distribution of shares.As a result, from an accounting perspective, it is preferable to place the issue of oversubscription within the overall framework of application and allocation, i.e. receipt of application amount, amount payable on allotment, and receipt from shareholders, as observed in the pattern of entries.

First, if the directors decide to accept some applications while rejecting others, the application fees paid for rejected applications are fully reimbursed. For example, a corporation requested applications for 20,000 shares and received 25,000 applications. The board of directors rejected the applications for 5,000 shares in excess of the required amount and refunded the applicants' application fees in full. In this example, the journal entries for application and allocation will look like this:

This alternative's journal entries on application and allotment are as follows:

Bank A/c Dr.

To Share Application A/c

(Money received on application for 25,000 shares)

Share Application A/c Dr.

To Share Capital A/c

To Bank A/c

(Transfer of application for money 20,000 for shares allotted

and money refunded on applications for 5,000 shares rejected)

Share Allotment A/c Dr.

To Share Capital A/c

(Amount due on the allotment of 20,000 shares)

Bank A/c Dr.

To Share Allotment A/c

(Allotment money received)

Second, if the directors choose to make a proportionate allotment to all applicants (also known as 'pro-rata' allotment), any surplus application money is generally applied to the sum owing on allotment. If the surplus application money collected exceeds the amount due on share assignment, the excess amount may be reimbursed or credited to calls in advance.

For example, if applications for 20,000 shares are invited but only 25,000 are received, it is decided to allot shares in a 4:5 ratio to all participants. It is a situation of pro-rata allotment, and the excess application money collected on 5,000 shares would be applied to the amount owing on the 20,000 share allotment.

Bank A/c Dr.

To Share Application A/c

(Application money received on 25,000 shares)

Share Application A/c Dr.

To Share Capital A/c

To Share Allotment A/c

(Transfer of application money to share capital and the excess application money on 5,000 shares credited to share allotment a/c)

Share Allotment A/c Dr.

To Share Capital A/c

(Amount due on allotment of 25,000 share)

Bank A/c Dr.

To Share Allotment A/c

(Allotment money received after adjusting the amount already received as excess application money)

Third: If an application for some shares is denied outright and a pro-rata allotment is provided to the remaining applicants, the money on rejected applications is forfeited, applications are repaid, and any extra application funds received from applicants who have received pro-rata allotment are adjusted toward theamount owed on the allotment of shares.

1.6.3 Issue of Shares at a Premium

It is extremely normal for shares of financially successful and well-managed corporations to be issued at a premium, that is, at a price higher than the nominal or par value of the shares. When a share with a nominal value of Rs. 100 is issued at Rs. 105, it is said to have been offered at a 5% premium. When shares are issued at a premium, the amount of the premium can technically be called at any step of the process. However, premium is usually called with the sum due on allotment, occasionally with the application money, and only rarely with the call money. The premium money is credited to a separate account called 'Securities Premium Account,' which is reflected on the company's balance sheet statement under the heading 'Reserves and Surpluses.'

It can only be used for the four purposes specified in Section 78 of The Companies Act 1956: (a) to issue fully paid bonus shares up to the unissued share capital of the company; (b) to write-off preliminary expenses of the corporation; (c) to write-off expenses of, or commission paid, or discount allowed on any of the company's shares or debentures; and (d) to pay premium on the redemption of preference shares or debentures of the company.

The following are the journal entries for shares issued at a premium:

For Premium Amount called with Application money

Bank A/c Dr.

To Share Application A/c

(Money received on application including premium)

Share Application A/c Dr.

To Share Capital A/c

To Securities Premium A/c

(Transfer of application money to share capital and securities premium account)

Premium Amount called with Allotment Money

Share Allotment A/c Dr.

To Share Capital A/c

To Securities Premium A/c

(Amount due on allotment of shares including premium)

Bank A/c Dr.

To Share Allotment A/c

(Allotment money received including premium)

Example -Jupiter Company Limited issued 35,000 equity shares of Rs. 10 a per share, with a Rs.2 premium payable as follows:

Rs. 3 on application, Rs. 5 on allotment (including premium)

First and Last Call Balance

The issue was completely sold out. The money was received in full.

Make journal entries in the Company's books.

Jupiter Company Limited Journal Books

Bank A/c Dr. 1,05,000

To Equity Share Application A/c 1,05,000

(Money received on applications for 35,000 shares)

Equity Share Application A/c Dr. 1,05,000

To Equity Share Capital A/c 1,05,000

(Transfer of application money on allotment to share capital)

Equity Share Allotment A/c Dr. 1,75,000

To Equity Share Capital A/c 1,05,000

To Securities Premium A/c 70,000

(Amount due on allotment of 35,000 including premium)

Bank A/c Dr. 1,75,000

To Equity Share Allotment A/c 1,75,000

(Money received including premium)

Equity Share First and Final Call A/c Dr. 1,40,000

To Equity Share Capital A/c 1,40,000

(Amount due on First and Final Call on 35,000 shares)

Bank A/c Dr. 1,40,000

To Equity Share First and Final Call A/c 1,40,000

(Money received on First and Final Call)

1.7 Forfeiture of Shares

Some shareholders may fail to pay one or more instalments, namely allotment money and/or call money. In such cases, the company may forfeit their shares, i.e. reject their allotment and deem the amount already received as forfeited to the business under the terms of its articles. These clauses are often based on Table A, which authorises the directors to forfeit shares for failing to pay calls made. They must strictly adhere to the protocol established for this purpose.

The accounting treatment of shares issued at par, premium, or discount is as follows. When shares are forfeited, all entries in the accounting records relating to the forfeited shares, except those relating to premium, must be reversed. As a result, the sum is deducted from the share capital account, calls in respect of shares are forfeited, and the amount previously received is credited to the corresponding unpaid calls accounts or calls in arrears accounts.As a result, the journal entry will look like:

Forfeiture of Shares issued at Par:

Share Capital A/c..........(Called up amount) Dr.

To Share Forfeiture A/c...........(Paid up amount)

To Share Allotment A/c

To Share Calls A/c (individually)

(Shares forfeited for non-payment of allotment money and calls made)

The journal entry to record the forfeiture of shares issued at a premium but not completely received will be:

Share Capital A/c Dr.

Securities Premium A/c Dr.

To Share Forfeiture A/c

To Share Allotment A/c

and/or

To Share Calls A/c (individually)

(Shares forefeited for non-payment of allotment money and calls made)

Re-issue of Forfeited Shares

The directors have the option of cancelling or reissuing the forfeited shares. In most situations, they reissue such shares at par, a premium, or a discount. Shares that have been forfeited may be reissued as fully paid at a par, premium, or discount. It should be highlighted in this context that the amount of discount allowed cannot exceed the amount received on forfeited shares at the time of initial issue, and that the discount allowed on reissue of forfeited shares should be deducted from the 'Forfeited Share Account.' The remaining sum in the Share-Forfeited Account from reissued Shares should be recognised as capital profit and transferred to the Capital Reserve Account.

For example, if a corporation forfeits 200 Rs. 10 shares for which it paid Rs. 600, it can accept a maximum discount of Rs. 600 on their reissue. Assuming the corporation reissues these shares for Rs. 1,800 as fully paid, the following journal entry is required:

Bank A/c Dr. 1,800

Share Forfeiture A/c Dr. 200

To Share Capital A/c 2,000

(Reissue of 200 forfeited shares at Rs. 9 per share as fully paid)

This results in a Rs. 400 amount in the share forfeited account, which should be moved to the

Capital Reserve Account by making the following journal entry:

Share Forfeiture A/c Dr. 400

To Capital Reserve 400

(Profit on reissue of forfeited shares transferred)

Summary

- Company, an organisation made up of persons known as "shareholders" because they own shares in a company and can act as a legal person in terms of its business through its board of directors.
- Share is a fraction of a company's capital that serves as the basis for ownership.
- According to the rules of the Companies Act of 1956, shares are classified into two types: equity shares and preference shares. Again, preference shares are classified according to the degree of rights linked to them.
- Share capital is raised by issuing shares to either a restricted group of people through private placements or to the general public for subscription. Thus, the issuance of shares is fundamental to a company's capital.
- Shares can be issued for cash or for non-monetary value, with the former being more prevalent. When a firm purchases a business or some asset/assets and the sellers have agreed to accept payment in the form of fully paid shares of a company, shares are said to be issued for consideration other than cash.
- Shareholders may fail to pay one or more instalments on shares assigned to them. In such a circumstance, the corporation has the authority to forfeit the defaulters' shares. This is known as share forfeiture.' Forfeiture is the cancellation of an allotment owing to a breach of contract, and the sum already received on such shares is considered forfeited to the corporation.

Keywords

- Share capital
- Forfeiture of shares
- Share Premium
- Pro-rata allotment of shares
- Under/Over Subscription

Self Assessment

1. The incorporation of a company creates an artificial entity recognised by law as a legal person with rights and liabilities.

A. True
B. False

2. All shareholders are responsible up to the amount of unpaid share capital,but are not accountable for the company's actions.

A. True
B. False

3. Every member of a corporation has the right to participate in its management.

A. True
B. False

4. What is Reserve Capital.

A. Uncalled capital

B. Issued capital

C. Called up when the company is shutting down.

D. Paid up capital

5. Capital profits are used to develop capital reserves.

A. True

B. False

6. The securities premium account is shown on the _______ side.

A. Balance sheet's assets

B. Balance sheet's liability

C. Balance both side

D. Income statement

7. Who are Equity shareholders?

A. Suppliers

B. Stakeholders

C. Creditors of the company

D. None

8. Why shares are forfeited :

A. Due to non-payment of call amount

B. Due to absence from meetings

C. Non-payment of bank loan

D. A & B

9. Where shares forfeited are transferred?

A. Redemption reserve

B. CRR

C. Capital reserve

D. Reserve & Surplus

10. The premium at the time of issuing of shares is a capital loss.

A. True

B. False

11. A share issue i.e. not open to the public, but is offered to a special persons is known as .

A. Public offering

B. FPO

C. IPO

D. None

12. The share capital account is debited with ____, when shares are forfeited.

A. Share nominal value

B. Share market value

C. Share called up value

D. Shares' paid-up value

13. The securities premium cannot be used for __________.

A. To distribute dividends to members

B. To distribute bonus shares to members

C. To deduct the company's preliminary expenses

D. To deduct the discount on the issuance of debentures.

14. What is the difference between subscribed and called up capital?

A. Arrear calls

B. Advance calls

C. Uncalled capital

D. None

15.If a share of 10 is forfeited on which 8 is called and 6 is paid, tell the amount for which Share Capital Account is debited with?

A. 8

B. 9

C. 6

D. 12

Answer for Self Assessment

1.	A	2.	A	3.	B	4.	C	5.	A
6.	A	7.	B	8.	A	9.	C	10.	B
11.	D	12.	C	13.	A	14.	D	15.	A

Review Questions

1. Define Company and its features?

2.What are the differenceEquity shareholder and debentures holder?

3. Explain various types of capital a company is to show in its balance sheet?

4. The Texla Company Limited issued 20,000 equity shares of Rs.10 each at a 10% premium, payable at Rs.2 on application, Rs.4 on allocation including premium, Rs.3 on First Call, and Rs.2 on Second and Final Call. There were 26,000 applications for shares. 4,000 share applications were turned down. The remaining applications were allocated on a pro-rata basis. Both calls were made, and all funds were received with the exception of the final call on 500 shares, which was forfeited. 300 of the forfeited shares were eventually reissued as fully paid shares at a price of Rs.9 per share. Prepare the balance sheet and journal entries.

5. Machine Tools Limited issued 50,000 equity shares of Rs.10 each at Rs.12 per share, with Rs.5 due on application (including premium), Rs.4 payable on allotment, and the balance payable on the first and final call. 70,000 share applications had been received. The cash received was refunded, and the remaining Rs.60,000 was put to the sum payable on allotment. Except for one shareholder with 500 shares, all stockholders paid the call. These shares were forfeited and reissued at Rs.8 per share as fully paid. Journalise the transactions.

Further Readings

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- S.N. Maheswari, Management Accounting.
- Ravi M. Kishore, Advanced Management Accounting; Taxmann's, Taxmann Publication (P) Ltd. 59/32, New Rohtak Road, New Delhi – 110 005.
- Baker, Lembke King, Jeffrey, & Christensen, Advanced financial accounting, McGraw-Hill/Irwin.

Web links

https://www.ig.com/en/glossary-trading-terms/share-buyback-definition

https://www.hdfcsec.com/buyback

Dr. Sachin Kashyap, Lovely Professional University

Unit 02:Right Issue and Bonus Issue of Shares

CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the fundamental meaning of rights issue and a bonus issue shares,
- Distinctions between a rights issue and a bonus issue;
- Explain the accounting treatment of rights issue and a bonus issue of shares issued

Introduction

Share capital is the most common and convenient form of long-term financing for businesses. To raise public funding from the capital market, the organizations use a variety of concerns. IPOs and FPOs are two types of issues in which a firm issues (sells off) financial securities such as equity shares to investors. Other sorts of issues that firms use to obtain money and as cash alternatives in various situations include the right issue and bonus issue.

Listed firms frequently reward shareholders by issuing extra stocks or shares through bonus and rights issues. There are significant distinctions between a rights issue and a bonus issue. Investors must grasp this so that they are not perplexed when making key investing decisions. Existing shareholders are not required to participate in the rights offering. Investors may also sell their stock before the record date if they are not interested in participating in the appropriate issuance. When a company wants to infuse new cash into the company, it creates the appropriate issue. In other words, right shares are a better option for capital infusion for businesses than high-interest bank loans. The funds raised through a right issue might be utilized to expand a business. Bonus shares, on the other hand, are issued by a corporation when it develops a big free cash reserve. It improves shareholder sentiment and brand impression. Simply put, a bonus issue is created from the company's reserves in order to reward its shareholders.

2.1 Right Issue of Shares

Issuing securities to existing shareholders is one approach for a public corporation to raise more money. This is referred to as a rights issue. A public limited company may issue rights under Section 81(1) of the Companies Act. It is distinguished by the fact that it is limited to the company's current shareholders. It could be by a publicly traded corporation, either listed or unlisted. If the offer allows it, the shareholders may surrender their entitlement in favor of other shareholders.

2.2 Provision Concerning the Right to IssueShares

Companies Act Provisions

The Articles of Association govern the rights issue of shares, which must be authorized by an ordinary resolution of the members in a public meeting. The shareholders are offered the rights issue in the same proportion that they own shares in the company. If the firm wishes to offer shares to people other than its existing owners, it must obtain a special resolution under Section 81 (1A). This category includes a private placement or preferential share distribution. However, the Companies Act, Section 81(1), does not apply to a private limited company.

SEBI Guidelines

The following are the essential requirements of the SEBI DIP Guidelines:

(a) Except where the aggregate value of the securities does not exceed Rs. 50 lakhs, the DIP Guidelines apply to all rights offerings by listed firms. In such circumstances, the letter of offer must be drafted in accordance with the SEBI disclosure requirements and filed with the SEBI.

(b) The eligibility guidelines for an initial public offering or a public issue do not apply to a rights issue.

(c) The pricing of a rights offering is at the discretion of the company and merchant bankers. In the event of a public-cum-rights issue, the firm may charge different prices for the two issues.

(d) The promoter contribution and lock-in period requirements do not apply in the case of a rights issue.

(e) Rights issue shall be kept open for a minimum of 30 days and a maximum of 60 days.

(f) Once the stock exchanges have determined that a minimum of 90% of the subscription has been obtained, the issuing company may use the cash raised from the rights issue.

Takeovers Regulations

The substantive restrictions of the SEBI takeover regulations do not apply to a rights issue allotment given to a shareholder to the extent of his entitlement and up to the 55 percent limit established in Regulation 11. This limit, however, can be exceeded if the acquisition is done by any person in control who has stated in the letter of offer that he intends to acquire more shares beyond their entitlements if the issue is undersubscribed. However, if the acquisition results in a change in management control, this exemption will be unavailable.

Provisions of FEMA

A person residing outside India may purchase equity or preference shares or convertible debentures on a right basis if:

(i) The offer on a right basis does not result in an increase in the percentage of foreign equity already approved or permissible under the FDI Scheme;

(ii) The existing shares or debentures in exchange for the rights are held in compliance with the FEMA regulations.

(iii) Existing non-resident shareholders may apply for additional shares as long as the total number of shares issued to non-residents does not exceed the sectoral cap.

(iv) The offer on right basis to people residing outside India is made at a price that is not less than that given to resident shareholders.

Purchase of right shares or debentures by a person residing outside India are subject to the same limitations, including limits on repatriation, as the original shares against which the right shares or debentures are issued.

2.3 Conditions relating to Right Issue

Before going through the Right Issue procedure, a company must meet the following requirements:

- Every unlisted company making a right issue offer must have its securities converted into a dematerialized form. The KMP (Key Management Personnel), Directors, and Promoters hold these securities in accordance with the provisions of the Depositories Act, 1996;
- Any shareholder who wishes to subscribe for the shares offered must also have their securities transformed into dematerialized form.
- A corporation must determine whether its authorized capital is sufficient to issue the appropriate shares. If not, the company must amend the capital provision of its MOA (Memorandum of Association); • A company must determine whether the AOA (Article of Association) authorizes the issuance of the appropriate shares. If not, the firm must amend the AOA to include the provision for the rightissue;
- A company can only issue the right shares to its shareholders.

Who is eligible to apply for Right Issue?

According to Section 62 of the Companies Act of 2013, the following entities are eligible to apply for the Right Issue:

- **Current Shareholders**: By sending a letter of offer to its current shareholders, a corporation can issue right shares in proportion to their shareholdings. However, in order to issue rights shares, a firm must meet the following requirements:

1. A corporation must submit a letter of offer to shareholders, including the amount of shares offere d.The shareholders must take the proposal within a minimum of 15 days and a maximum of 30 day s;

2. If the shareholders do not take this offer within the tentative time period, the offer is declined;

3. It also includes the right to renounce the shares given in favour of another person;

4. Following the expiration of the required term or receipt of an intimation from the shareholder reg arding their rejectinof the shares offered, the BOD (Board of Directors) may organize the shares in a manner beneficial to both the company and the shareholders.

- **Employees**: By passing a special resolution and meeting certain conditions, a corporation might issue the right shares to its employees under an ESOP (Employee Stock Option Plan).
- **Any other person**: A corporation can also issue the right shares to any other person for cash or for compensation other than cash. The registered valuer, on the other hand, decides the price of such shares by issuing a valuation report pursuant to stipulated circumstances.

Procedure for Right Issue:

The method for issuing shares is outlined in Section 62 (1) of the Companies Act 2013.

- Distribution of Board meeting notices: According to Section 173(3) of the Companies Act 2013, the notice for the board meeting must be delivered at least seven days before the meeting and must include the agenda.
- Call the First Board Meeting: The first Board meeting is called, and the resolution to issue rights shares is approved. Because the rights issue does not require shareholder approval, the board may proceed with the issue.
- Issue Letter of Offer: After the resolution is passed, the letter of offer is sent to all shareholders via registered or speed post. A window term of 15 – 30 days is provided for shareholders to accept the offer, which means that the most time the shareholders can take to accept the offer is 30 days and the minimum duration is 15 days. If the offer is not

accepted before the expiry date, it is considered declined. The offer must be open for at least three days after the letter of offer is issued.

- File MGT – 14: After the board resolution is passed, the corporation must file the MGT -14 within 30 days of the Board Resolution being passed. A public limited company must file the MGT-14 form alongwith a true certified copy of the Board Resolution.
- Receive application money: Shareholders must send the accepted application as well as the application money.
- Call the Second Board Meeting: The Corporation must call the second board meeting, and notice of the meeting must be issued 7 days in advance. A quorum is necessary, and the resolution for the allotment of shares must be passed. After passing the resolution for share allotment, the shares must be allotted within 60 days of receiving the application money.
- File the forms with the ROC: The firm must file Form PAS -3 with the Registrar of Companies within 30 days of the allotment of the shares. The form must be accompanied by a certified authentic copy of the Board Resolution and a list of allottees. Furthermore, the MGT – 14 must be filed for both share allotment and issue.
- Share Certificates: Share certificates must be issued; if the shares are in Demat form, the corporation must notify the depository promptly upon share allotment. If the shares are held in physical form, the share certificates must be issued within two months of the day the shares were allotted. At least two directors must sign the share certificate and it should be issue in form SH-1.

2.4 Benefits of Right Issue of Shares

1. It is a quick source of raising funds- Issuing rights is the quickest and cheapest way for a company to raise funds. On the right issue, our shareholders can purchase new shares at a discount for a limited time. The right issue involves less stringent rules and regulations because it is more of an internal company matter.

2. The right issue is inexpensive- Without incurring underwriting expenses, a firm can commence the rights issue procedure to its current shareholders at any time. The corporation also saves money on advertising, underwriting fees, and other expenses. In comparison to raising new equity from investors, the company does not have to suffer such costs.

3. The right issue gives shareholders the choice to keep their current shareholding-An current shareholder's ability to purchase new shares is always proportional to his existing shareholding. Shareholders can choose to keep their original proportion of share ownership. Existing shareholders will have a better chance of receiving shares if a new issue is made to existing shareholders rather than the general public. The right issue's share price will be lower than the present share price, attracting existing shareholders.

4. Raise finances without incurring debt- The right issue is a capital-raising mechanism in which the company can raise funds without incurring further debt. The corporation can raise funds from its existing shareholders without changing their ownership percentage. The scope of the right issue is entirely in the form of stock, with no room for debt.

5. The board of directors may not abuse the option to issue shares-The board must not throw away the chance to issue fresh shares at a reduced price. The right issue shares are distributed proportionally to existing shareholders based on their current ownership. Directors have little control over the right issue.

2.5 Disadvantages of Right Share Issue

1. The current shareholding percentage may be reduced- Existing shareholders can either 'subscribe' or 'ignore' the appropriate issue. If a shareholder chooses to 'ignore' the right problem, their shareholding % will be reduced. This is due to the extra shares issued by the corporation if existing shareholders 'ignore' it. If more shareholders 'ignore' the correct issue, existing

shareholders' stakes may be diluted. As the existing shareholder proportion decreases due to the introduction of new owners, the existing shareholders may face difficulties.

2. Following the right issue, the share price falls- Following the proper issuance, a specific percentage of shares will be newly introduced at a reduced price. As a result, the previous share price is diluted. Dilution occurs when a new substantial number of shares dilutes the company's net profit.

3. Fundraising Capacity- Most stock exchanges have set limits or restrictions on how much a firm can raise through a rights issue. This restriction is normally set based on the firm's current equity worth. In comparison to an IPO, the company cannot raise as much money (Initial Public Offering). If a firm's stocks are undervalued, raising capital through the right issuance may put pressure on the company.

4. The damaging impact on the company's image-The right issue is an indication of a company's liquidity crisis. In general, corporations will choose the best issuance choice in the event of a financial crisis. When the appropriate issue is announced, the company's brand name may suffer. In another case, shareholders may believe that the company is failing to manage its business and may sell their shares, lowering the share price even further.

Accounting Treatment

The accounting entry for a right share issue is similar for a standard share issue, but with a lesser price.

XYZ Co., for example, has 100,000 issued shares with a nominal value of $10 and a market value of $15 per share. The company encourages its shareholders to participate in a rights offering of one share for every five shares for $10 per share. This means that the corporation is issuing 20,000 (100,000 x 1 / 5) shares to its owners at a $5 ($15 – $10) discount. Assuming that all of the issues are approved by the shareholders, the accounting entry will look like this:

Bank (20,000 x $10) A/c Dr	200,000	
To Share Capital A/c (20,000 x $10)		200,000
(Being issue of right shares @ 10$)		

If the correct share issue price is $12 rather than $10, the accounting entry will be as follows:

Bank (20,000 x $12) A/c Dr	240,000	
To Share Capital (20,000 x $10)		200,000
To Share Premium (20,000 x ($12 – $10))		40,000
(Being issue of right shares at premium of 2$)		

Difference between Public Issue and Right Issue of shares

Public issue	Right issue
1. It is the most prevalent means of raising money from the general population. It is described as the issuance of shares to the public rather than being privately funded by the company's own promoters, which may not be sufficient funding for the business to start up, generate, or continue operating.	1. A rights issue is sale of rights to purchase additional securities in a corporation to existing security holders. When the rights are for equity securities, such as shares in a publicly traded business, it is a seasoned equity offering.
2. By issuing shares publicly, the people can own a portion of the corporation but not exercising control.	2. Existing security holders with right issue, have the option to purchase a specific number of new securities from the firm at a given price within a specified time frame. A rights issue is a type of public offering in a public corporation (different from most other types of public offering, where shares are issued to the general public).

3. There is a possibility of oversubscription or under subscription, so shares will be allocated proportionately or on pro-rata basis.	**3.**There are no chances of oversubscription or under subscription and so, there can be no pro-rata allotment of shares.
4. Prospectus or advertising are used to communicate.	**4.** The mode of communication is through meetings, emails or other suitable channel between company and existing shareholders.

2.6 Bonus Issue of Shares

The issuance of bonus shares is a commonfeature in the corporate sector.When the company has a substantial profit surplus and intends to convert it into share capital, it might issue bonus shares to ownmembers in proportion to their respective holdings. Bonus Shares are issued to capitalize the Company’s profits or reserves. It is also known as "Capitalisation Shares" since these shares are issu ed when profits or reserves are capitalised. The primary goal is to diversify the Company's share ca pital. The issuance of bonus shares results in no cash outflow. The provisions for the issuance of bonus shares are found in Section 63 of the Companies Act of 2013.

Conditions as specified for issue of bonus shares (as per section 63 rule 14 of companies (share capital & debentures) rules, 2014

- Source of bonus share issue- A firm may issue fully paid-up bonus shares to its members in any manner from — its free reserves; the securities premium account; and the capital redemption reserve account. The Company cannot issue bonus shares by capitalizing reserves resulting from asset revaluation.
- Articles of Association authorization(AOA)- AOA must approve the bonus issue, if the AOA do not authorize the issuance of bonus shares, the same must be terminated in accordance with Section 14 of the Act.
- Authorization of Bonus Issue in General Meeting- The issue of bonus shares must be previously authorized in the Company's General Meeting, either by passing an ordinary resolution or, if the Articles of Association require it, by passing a special resolution. On the recommendation of the Board of Directors, the aforementioned resolution will be passed.
- Bonus shares are not permitted in the case of partially paid shares -The Company cannot issue bonus shares to shareholders who own partially paid-up shares; nevertheless as of the date of allotment, the partially paid shares are made completely paid-up before bonus shares are issued.
- Restriction on issue of Bonus Shares- The company can capitalize its profits or reserves for the purpose of issuing fully paid-up bonus shares only if: I it has not defaulted in payment of interest or principal on fixed deposits or debt securities issued by it; and (ii) it has not defaulted in payment of employee statutory dues such as provident fund contribution, gratuity, and bonus.
- Bonus shares in place of dividends Bonus shares will not be offered in place of dividends.
- No bonus issue can be withdrawn- Rule 14 of the Companies (Share Capital & Debentures) Rules, 2014 states that if a company that has announced its Board of Directors' decision to discontinue a bonus issue, it may not withdraw it afterwards.

2.7 Important Issues Relating to Issue of Bonus Shares

a. Quantity of Bonus Shares- The number of bonus shares or the ratio of bonus shares shall be determined by the company's reserves and surplus, as well as the management's aim on the amount of reserves and surplus to be capitalized.

b. Where authorizedcapital has been depleted (Sanjay Paliwal v. Paliwal Hotels P. Ltd., 2007, 79 CLA 431-CLB), it was held that because the authorized capital had already been depleted on the date of the purported allotment, no further allotment of shares could take place. As a result, before beginning the process of issuing shares, the company should first increase its authorized share capital, and then begin the process of issuing shares. However, in the case of approving shareholders resolution for improvement in authorized share capital and resolution for Issue of Bonus Shares in the Same General Meeting, both resolutions can be passed simultaneously.

c. Eligibility for Bonus Shares- Bonus shares are only available to those who are members on the cutoff date determined by the Board of Directors. A person who transfers his shares before the cut-off date is not eligible for the bonus share (Quality Assurance Institute India Ltd. v. Rajiv Nag).

Process for issuing bonus shares

1. Before proceeding with the decision to issue bonus shares, the management should ensure that all of the requirements or prohibitions mentioned in Section 63 of the Companies Act, 2013 and Rule 14 of the Companies (Share Capital & Debentures) Rules, 2014 are met.

2. Call a Board Meeting, after providing all directors with seven days' notice in accordance with Section 173(3), to approve the following:

- Distribution of Bonus Shares to shareholders.

- The number of bonus shares to be issued, as well as the ratio at which the shares will be offered as Bonus Shares.

- Select a date, time, and location for the Extraordinary General Meeting (EGM).

3. Submit Form M G T-14 within 30 days after enacting a Board Resolution* for the issuance of bonus shares in accordance with Sections 117 & 179(3) (c). The necessity to register M G T-14 is waived for private firms pursuant to Notification No. GSR 464(E) dated 05.06.2015 and for IFSC Public Limited Companies pursuant to Notification No. GSR 8(E) dated 04-01-2017.

4. Call an Extraordinary General Meeting to address the following issues:

- Adopt an Ordinary Resolution** (or Special Resolution, if specified in the Company's Articles of Association) to approve the Bonus Issue.

- The number of bonus shares to be issued, as well as the ratio at which the shares will be offered as Bonus Shares.

5. Submit Form M G T-14 to R O C within 30 days if the Company approves a Special Resolution authorizing the Bonus Issue, together with an explanatory statement***.

6. Call a Board Meeting after providing all directors with seven days' notice in accordance with Section 173(3), for the purpose of enacting a resolution authorizing the allotment of Bonus Shares and the issuance of Share Certificates.

7. Submit the allotment return in Form PAS-3 within 30 days after the allocation date, along with the following attachments:

- List of allottees**** containing the following information: the full name, address, Permanent Account Number, and E-mail ID of such shareholders; the class of shares owned; the date of allotment of shares; and the nominal value of such shares

- A certified copy of the Board Resolution* passed for Bonus share issuance.

8. In the event of a share allotment, issue new share certificates in Form SH-1 or any other required form to all people to whom shares have been allotted within 60 days of the date of allotment.

9. When share certificates are issued to shareholders, the Register of Members is updated.

2.8 Advantages of Bonus Issue of Shares

From the Perspective of an Investor

1) When obtaining bonus shares from the corporation, investors are not required to pay any taxes.

2) Bonus shares are advantageous for long-term shareholders who want to multiply their investment.

3) Bonus shares are free to shareholders because they are issued by the company, increasing an investor's outstanding shares and increasing the stock's liquidity.

4) Bonus shares help an investor create faith in the firm's business and operations since they have invested in the company and, as a result, provide funds to the investor.

From the Company's Perspective

1) The issuance of bonus shares raises the company's worth and market position, winning the trust of existing shareholders and attracting several small investors to the stock market.

2) With the issuance of bonus shares on the market, the companies have more free-floating shares.

3) The issuance of bonus shares helps corporations get out of a scenario in which they are unable or prefer not to pay cash dividends to their shareholders.

2.9 Disadvantages of Bonus Shares

1) From the standpoint of an investor, there is no significant point to possessing the bonus shares. However, they should be aware of the possibility of acquiring bonus shares because the profit will remain constant, but the number of shares will be increased as earnings per share fall.

From the Company's Perspective

1) When issuing bonus shares, the corporation does not get any cash. As a result, the opportunity to raise funds by following an offering is greatly reduced.

2) When a corporation continues to issue bonus shares instead of paying dividends, the cost of the bonus given accumulates over time.

Journal entries for the issue of fully paid-up bonus shares

Particulars	Dr/Cr	Debit (Rs)	Credit (Rs)
Sanction of bonus issue out of various reserves			
Capital Redemption Reserve Account	Dr.	XXXX	
Securities Premium Account	Dr.	XXXX	
General Reserve Account	Dr.	XXXX	
Profit & Loss Account	Dr.	XXXX	
To Bonus to Shareholders Account	Cr.		XXXX
Issue of bonus shares – Capitalization of profit			
Bonus to Shareholders Account	Dr.	XXXX	
To Share Capital Account	Cr.		XXXX

Journal entries for bonus issue by converting partly paid shares into fully paid shares

Particulars	Dr/Cr	Debit (Rs)	Credit (Rs)
Sanction of bonus issue			
General Reserve Account	Dr.	XXXX	
Profit & Loss Account	Dr.	XXXX	
To Bonus to Shareholders Account	Cr.		XXXX
Making the final call due			
Share Final Call Account	Dr.	XXXX	
To Share Capital Account	Cr.		XXXX
Adjustment of final call due			
Bonus to Shareholders Account	Dr.	XXXX	
To Share Final Call Account	Cr.		XXXX

Illustration

The following items exist in XYZ Limited's trial balance statement as of March 31, 2021:

90,000 Rs 10 equity shares = 9,00,000, 150,000 in Capital Redemption Reserve, 70,000 in Securities Premium 1,000,000 in the General Reserve, Profit & Loss Account Surplus = 80,000. The corporation decided to issue bonus shares at a rate of one for every three shares owned.

Solution- In the case given, the number of bonus shares to be granted Equals (90000 shares/3) = 30,000 shares.

Bonus share value = 30,000*10 = Rs 3,000,000

Journal entries in the books of XYZ Limited

Particulars	Dr/Cr	Debit (Rs.)	Credit (Rs.)
Capital Redemption Reserve Account	Dr.	1,50,000	
Securities Premium Account	Dr.	70,000	
General Reserve Account (Balancing figure)	Dr.	80,000	
To Bonus to Shareholders Account	Cr.		3,00,000
(For bonus issue of one share for every four shares held out of various reserves)			
Bonus to Shareholders Account	Dr.	3,00,000	
To Share Capital Account	Cr.		3,00,000
(For capitalization of profits)			

Difference between Bonus Shares and Right Shares

Points	Bonus Shares	Right Shares
Meaning	Bonus shares are free shares granted by a firm to its current shareholders on a pro-rata basis from free reserves.	Each issue is known as the right issue when a corporation issues more shares to current shareholders in proportion to their holding.
Cash Flow	There is no cash flow for the corporation in the event of a bonus issue.	There is cash flow for the corporation in the event of a right issue.
Consideration	In the event of a bonus issue, the company receives no consideration.	As shares are issued in exchange for cash, the company receives consideration.
Authorization	The bonus issue is based on the board's recommendations and authorization from the company's general meeting.	In the case of a right issue, authorization from members via ordinary or extraordinary resolution is required.
Market Value	The issuance of bonus shares has no effect on the company's market value.	The right issuance of shares has an impact on the company's market value.
Section	Section 63 of the Companies Act of 2013 governs and regulates it.	Section 62 of the Companies Act of 2013 governs and regulates it.

Summary

The right shares is a prescribed invitation to existing shareholders of the company to purchase additional, new shares , which allows the existing shareholder the opportunity to purchase new shares at a discounted rate. The company's goal in issuing the Right issue is to strengthen an equitable distribution of shares. However, it has no effect on the shareholders' voting rights. Bonus Shares are issued to capitalize the company's profits or reserves. It is also known as "Capitalization Shares" since these shares are issued when profits or reserves are capitalized.

Keywords

- Right issue of shares
- Bonus issue of shares
- Board Meetings
- Extra ordinary meeting

Self Assessment

1. Tellthe section of the Companies Act of 2013 that deal with provisions relating to right issue of shares?

A. Section 60
B. Section 62
C. Section 64
D. Section 68

2. The provisions of section 62 of the Companies Act, 2013, relating to right issue of shares, apply to ____________ company?

A. Company without share capital
B. All corporations
C. Company with share capital
D. All of these

3. .... are free shares issued by a corporation to its current shareholders.

A. Right shares
B. Bonus shares
C. Stock options
D. Warrants

4. Bonus shares are free shares issued by a firm to its existing stakeholders on a pro rata basis from __________?

A. Free reserve
B. Distributed profit
C. General reserve
D. Any of the above.

5. What will happen, if an offer for right shares is not accepted within the stated time frame.

A. It is presumed to have been accepted

B. The company must hold the shares in abeyance
C. It is deemed to have been declined
D. It can later be accepted by the share-holders

6. Companies might offer right shares to existing shareholders by passing ____________?
A. Special Resolution
B. Board Resolution
C. An Ordinary Resolution
D. Exceptional Resolution

7. Tellthe section of the Companies Act of 2013 that deal with provisions relating to right issue of shares?
A. Section 62
B. Section 63
C. Section 64
D. Section 66

8. A corporation cannot issue fully paid-up bonus shares to its members from the following reserves?
A. Securities Premium
B. Capital Redemption Reserve
C. Revaluation Reserve
D. All of the Above

9. What does it means, If the company issues bonus shares at a ratio of 3:4?
A. For every two shares, three bonus shares will be issued
B. For every four shares, three bonus shares will be issued
C. For every five shares, three bonus shares will be issued
D. For every five shares, two bonus shares will be issued

10. Tell the mode by which the notice relating to the right issue shall be sent?
A. Registered Post
B. Speed Post
C. Electronic Mode
D. Any of the above

11. The notification involving the offer for right issue must be sent to all existing shareholders via registered post, speed post, or electronic means at least ______________ before the issue opens.
A. 13 days
B. 5 days
C. 7 days
D. 3 days

12. Who authorizes the issue of bonus shares?

A. Board of directors

B. Article of association of the company

C. Shareholders by ordinary resolution

D. All of the above

13. Which of the following Section 63 conditions must be met by the corporation before issuing a bonus?

A. It is permitted by the articles.

B. The company has not failed to pay interest or principal on fixed deposits or debt securities issued by it.

C. The company has not failed to pay employees' statutory dues such as PF contribution, gratuity, and bonus.

D. All of the above

14. Right shares are to be offered to the existing as well as outsiders?

A. True

B. False

15. The company issues the bonus shares at premium?

A. True

B. False

Answers for Self Assessment

1.	B	2.	C	3.	B	4.	D	5.	C
6.	C	7.	B	8.	C	9.	B	10.	D
11.	D	12.	D	13.	D	14.	B	15.	A

Review Questions

1. Define right issue of shares and Conditions relating to Right Issue?

2.What are the difference public issue and right issue of shares?

3. Define Bonus issue of shares and conditions as specified for issue of bonus shares Rules, 2014?

4. What are the differencebonus issue and right issue of shares?

5.ABC corporationhas a fully paid share capital of 1,00,000 equity shares @Rs. 10. The corporation has a Rs. 10,000 reserve fund and declares a bonus of Rs. 4,50,000. This incentive would be distributed in the form of fully paid equity shares at a premium of Rs. 5 per share. On the date of bonus issue issuance, shares are quoted at Rs. 20 per share. Pass the necessary journal entries?

6.XYZcorporation has a share capital of 10,000,000 equity shares of @Rs. 10, with Rs. 8 paid up. It has a Rs. 80,00,000 reserve fund. If it is decided to use the entire reserve fund in the following manner: (a) the existing shares will be fully paid up; and (b) each shareholder will be given bonus shares proportionate to his holdings for the remaining amount in the Reserve Fund, with the shares valued at Rs. 12 each.

Make the necessary journal entries to reflect the aforementioned transaction.

Further Readings

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Unit 03: Redemption of Preference Shares

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- The definition of Preference Share redemption;
- Specify the circumstances for redeeming Preference Shares;
- Discuss the accounting technique for Preference Redemption.
- Identify the procedure for redemption of preference shares?

Introduction

Preference Stocks or shares in relation to any corporation limited by shares are those that carry:

(a) the right to receive a fixed amount of dividend or the amount of dividend computed at a defined rate, e.g., 10% nominal value of shares and furthermore.

(b) The right to be paid the amount of capital put up as such shares if the company is dissolved. These can be of the following varieties:

- **Cumulative Preference Shares**: These shares are entitled to a fixed dividend rate regardless of profit or loss. If the corporation makes enough money, it will issue a dividend. If the company does not make enough profits, the dividend on cumulative preference shares will continue to accumulate until it is fully paid off; such arrears are carried forward to the following year and are paid out of the profits of the succeeding years. In the event of the company's dissolution, the arrears of dividend on these shares are payable only if the articles of association expressly state so. It should be emphasized that unless clearly specified otherwise in the articles, all preference shares are believed to be cumulative.
- **Non-cumulative Preference Shares**: Non-cumulative preference shares are ones in which dividend arrears do not accumulate. If there are no or insufficient earnings in a given year, shareholders will not receive anything or a partial dividend, and they will not be able to collect dividend arrears in the next year. In other words, unpaid dividends on such shares do not accumulate but lapse, i.e., the shareholders loses them forever.

- **Participating Preference Shares**: The holders of such shares are entitled to a fixed dividend rate as well as a share of the surplus earnings alongside equity shareholders. If there remain surplus assets after a specific rate of dividend has been paid to equity shareholders, the holders of such shares will be entitled to a share of the surplus profit as well. Such shares can only be issued if there is a specific provision in the memorandum, articles oforganization, or terms of issuance.
- **Non-participating Preference Shares**: The holders of such shares are only entitled to a fixed dividend rate and do not share in the surplus earnings. If the articles are silent, all preference shares are assumed to be non-participating.
- **Convertible Preference Shares**: These shares have the right to be converted into equity shares after a set period of time.
- **Non-convertible Preference Shares**: Non-convertible preference shares are those in which the holders have no right to convert their shares into equity shares. Preference shares are presumed to be non-convertible unless otherwise stated.
- **Redeemable Preference Shares**: Normally, the money received by the corporation on shares are not refunded unless the company is wound up. If authorised by its articles, a corporation limited by shares may issue preference shares that must be redeemed or reimbursed after a set length of time. As a result, the funds received on such shares can be refunded over the company's lifetime. In terms of issue and the Company's Articles in this regard,these are often specified at par or premium. By the time of redemption and whether or not the redemption will take place, even funds are raised by the issuance of redeemable preference shares, they must be returned to the company whether the firm is to be wound up or not. Since March 1, 1997, the corporation has been unable to issue irredeemable preference shares or shares that can be redeemed after the expiration date.

A business is not permitted to refund share money to its owners without the authorization of the court, according to Section 100 of the Companies Act 1956. A repayment of money to shareholders on capital account while the company is still in operation necessitates judicial approval in addition to the unique procedure. However, Section 80 of the Companies Act allows a business, if approved by its articles, to issue preference shares that can be redeemed at the company's discretion if the conditions set out in this section are met.

3.1 Conditions for Redemption of Preference Shares

Certain parameters are outlined in Section 80 of the Companies Act of 2013, which must be followed by the firm in order to make the decision.

3.1.1: Authorisation by Article of Association of the Company - If approved by the Article, the company limited shares may issue preference shares, which may be redeemed at the company's discretion after the expiration of the specified period.

3.1.2 Fully Paid-Up- Shares Preference shares cannot be redeemed unless they are fully paid. Partially paid up shares cannot be redeemed, unless they are fully paid. As a result, these partially paid accounts must be changed into fully paid accounts.

3.1.3 Out of Profits or Issue of New shares-Preference shares can be redeemed either from earnings available for dividend or from the proceeds of a fresh issue of shares (equity shares or new preference shares) made specifically for the purpose of redemption.

3.1.4 Establishment of a Capital Redemption Reserve When preference shares are redeemed with profits, the equivalent amount must be transferred from reserves to the Capital Redemption Reserve.

3.1.5 Capital Redemption Reserve Use A/c . The Capital Redemption Reserve A/c account can be used to issue fully paid bonus shares to shareholders. This account may not be lowered except in accordance with a court order relating to share capital reduction.

3.1.6 Redemption Time Frame If the redemption of shares is accomplished through the issuance of new shares, it must be completed within one month of the issuance of new shares.

3.1.7 Premium on Redemption Any premium on redemption of preference shares shall come from either the securities premium or the actual revenue or capital earnings.

3.2 Mandatory Requirement

i. These shares may be redeemed solely from the company's profits that would otherwise be available for dividend or from the proceeds of a new issue of shares made for the purpose of such redemption.

ii. These shares may be redeemed only when fully paid.

iii. If such shares are redeemed from the company's earnings, a sum equal to the nominal value of the shares to be redeemed shall be transferred from such profits to a reserve known as the Capital Redemption Reserve Account.

iv. In the event of such enterprises whose financial statements meet with accounting rules, the premium payable on redemption shall be paid out of the company's profits before the shares are redeemed. And, for every other company, such redemption premium shall be paid out of the company's profits or the company's securities premium account before such shares are redeemed.

v. Before such shares are redeemed, the premium payable on redemption of any preference shares issued on or before the beginning of this Act shall be provided for out of the company's profits or the company's securities premium account.

vi. Redeemable preference shares may be redeemed within 20 years of their issue date, subject to the stipulated circumstances, in the case of a corporation limited by shares, if permitted by its articles. A company engaged in the establishment and management of infrastructure projects, on the other hand, may issue preference shares for a period exceeding 20 years but not exceeding 30 years, subject to a minimum redemption of 10% of such preference shares per year from the 21st year onwards, on a proportionate basis, at the option of the preference shareholders.

3.3 Procedure for Redemption of Preference Shares

- Articles of Association (AoA) Amendment: The first step is to ensure that the company's Articles of Association (AoA) (in the case of a company limited by shares) authenticates the issue of preference shares that are liable to be redeemed within a period of not more than 20 years from their issue date, subject to the prescribed conditions). [For more information, see the Procedure for Altering Articles of Association (AoA).]
- Prior Intimation to the Stock Exchange of a Board Meeting [Regulation 50 of the SEBI (LODR), 2015]

  a. Listed entities shall notify the stock exchange at least two working days in advance, excluding the intimation date and the Board Meeting date, of the Board meeting at which the proposal for change in the form or nature of non-convertible securities listed on the stock exchange, or in the rights or privileges of the holders thereof, or change in the date of the interest/ dividend/ redemption payment of non-convertible securities is to be discussed.

  b. Listed entities must also notify the stock exchange not later than the beginning date of dispatch of notices in the case of the above-mentioned proposals or any meeting of non-convertible securities holders pertaining to the proposal of any matter affecting the rights or interests of non-convertible securities holders.

- Call a Board of Directors (BOD) Meeting [as per Section 173 and SS-1]

  a. Send a notice of the Board Meeting to all of the Company's Directors at their registered addresses at least 7 days before the meeting. In the event of an emergency, a shorter notice can be granted.

  b. Include the Agenda, Agenda Notes, and Draft Resolution with the Notice.

c. Hold a meeting of the Company's Board of Directors and pass the relevant Board Resolution-

- to allow redemption of redeemable preference shares from company earnings or proceeds of new share issuance.
- must authorizethe transfer of a sum equivalent to the nominal number of shares to be redeemed to the Capital Redemption Reserve if the shares are to be redeemed from the company's profits.
- to authorize the issuance of new shares up to the nominal value of the shares to be redeemed to existing shareholders, if the redemption is to be funded by the new issue of shares.
- to determine the record date in accordance with Regulation 60 of the SEBI (LODR), 2015, if the company has listed its non-convertible preference shares on the stock exchange; and
- to give authority tothe CS, CFO, or any director of the company to file the notice of redemption of preference shares with ROC. Any company that has listed its non-convertible preference shares securities on the stock market must quickly inform the stock exchange of any action that lead to the redemption of any non-convertible preference shares securities. [Sebi (LODR) Regulations, 2015, Regulation 51]
- A company that has listed its non-convertible preference shares securities on the stock exchange must notify the stock exchange of the record date at least 7 working days in advance, excluding the date of notification and the record date. [SEBI (LODR) Regulations, 2015, Regulation 60]
- Prepare and distribute Draft Minutes to all Directors for comment within 15 days of the conclusion of the Board Meeting, through Hand/Speed Post/Registered Post/Courier/E-mail. [Refer to the Procedure for Preparing and Signing Board Meeting Minutes]
- Redemption Amount

  The company shall pay the redemption amount and any premium amount (if any) to redeemable preference shareholders.

- Members' Register Entries That Are Relevant

  Within 7 days of the Board Meeting at which the redemption was approved, the company must make the relevant entries in the Register of Members in Form MGT-1.

- Corporate Activities

  Where the Company has allotted redeemable preference shares in demat format, the Company shall submit the relevant corporate action for the debit of preference shares from shareholders' accounts.

- Submit a Notice of Redemption of Preference Shares.

  Within 30 days of the date of redemption, the company must file a notice of redemption of preference shares with ROC in Form SH-7, accompanied with the accompanying documentation.

  a. A certified accurate copy of the board resolution enabling the redemption of redeemable preference shares is displayed, and redemption of redeemable preference shares is mandatory.

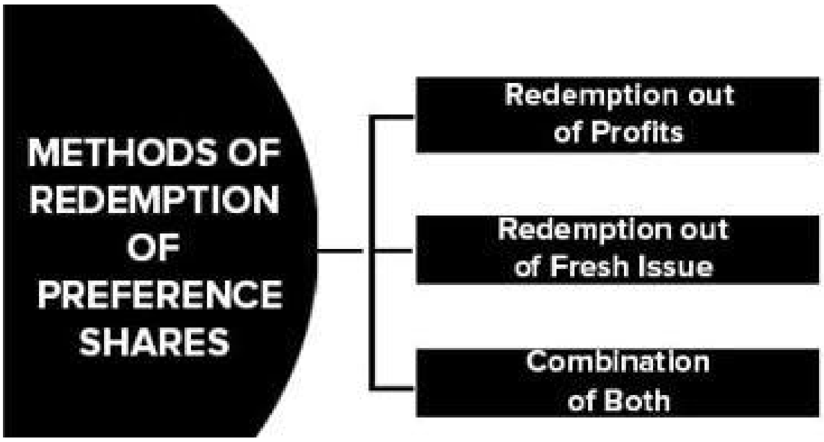
  b. Altered articles of association are required if the same are changed.

  c. Any further information can be included as an optional attachment (s).

- Transfer of Funds to the Capital Redemption Reserve Account

When the company redeems preference shares from its profits, a sum equal to the nominal amount of the redeemed preference shares is sent to the Capital Redemption Reserve Account (CRR).

Methods of Redemption of Preference shares-



3.4 3.4 Accounting/Methods for Redemption of Preference Shares

The following accounting entries will be passed for making the redemption of preference shares:

(1)**For converting partly paid-up shares fully paid up:** If the redeemable preference shares are partly paid, then before their redemption, they are made fully paid up.

(i) Redeemable Preference Shares Final Call Dr.

To Redeemable Preference Share Capital A/c

(ii) Bank A/c Dr.

To Redeemable Preference Share Final Call A/c

(2) **On issue of new shares:** If the preference shares are to be redeemed by issue of new shares, any of the following entry will be passed

(i) When shares are issued at par:

(a) Bank A/c Dr.

To Share Application & Allotment A/c

(b) Share Application & Allotment A/c Dr.

To Share Capital A/C

(ii) When shares are issued at premium:

(a) Bank A/c Dr.

To Share Application & Allotment A/c

(b) Share Application & Allotment A/c Dr.

To Share Capital A/c To Securities Premium A/c

(iii) When shares are issued at discount:

(a) Bank A/c Dr

To Share Application & Allotment A/C

b) Share Application & Allotment A/c Dr

Share Discount A/c Dr

To Share Capital A/C.

If the new shares are issued at par or at a discount, the actual amount received will be used for redemption, however if the new shares are issued at a premium, the amount received less the premium will be used for preference share redemption.

3) For redemption from profits: The remaining amount will be arranged from earnings after

comparing the face value of the preferential issuance of shares and the new issue of shares. Following entry made for this purpose:

Profit and Loss Appropriation A/c

General Reserve or any other Reserve A/c

To Capital Redemption Reserve A/c

Calculation of Amount of CRR A/C CRR = Amount of Preference shares

(4) **For premium due on redemption:** The premium on redemption of preference shares is provided first out of securities premium account and then out of profits. Following entry is made:

Securities Premium A/c Dr.

Profit and Loss A/c Dr.

To Premium on Redemption A/c

5) **For amount due on redemption of preference shares-**

Redeemable Preference Share Capital A/c

Premium on Redemption A/c

To Redeemable Preference Shareholders A/c

6) **For making the payment-**

Redeemable Preference Shareholder A/c

To Bank A/c

Example-

(Preference Share Redemption at Par) Pass the following journal entries:

(i) X Ltd redeems 6,000 Rs. 100 Redeemable Preference Shares at par. It issued 3,000 equity shares of Rs. 100 each at a 10% premium for this purpose, and the remainder was paid from the Profit and Loss Account having sufficient balance.

(ii) X Ltd redeems 10,000 Rs. 10 Redeemable Preference Shares at par. It issued 4,000 equity shares @ Rs. 10 at a 10% discount for this reason, and for the rest, it used Profit and Loss A/c having sufficient balance.

(iii) X Ltd redeems its 8,000 Rs. 10 Redeemable Preference Shares at par. It issued 3,000 equity shares @ Rs. 10 and for the remainder, it used Profit and Loss A/c having sufficient balance.

Solution:

(i) Amount of Preference Shares to be redeemed 6,00,000

Less: Amount of Equity shares issued 3,00,000

Amount utilised from P & L A/c 3,00,000

Bank A/c	Dr.	3,30,000	
To Equity Share Application and Allotment A/c			3,30,000
(For application money received on 3,000 Equity Shares @ Rs. 110 each)			
Equity Share Application and Allotment A/c	Dr.	3,30,000	
To Equity Share Capital A/c 3,00,000			
To Securities Premium A/c 30,000			
(For Transfer of application money on 3000 equity shares @ 110 each)			
Profit and Loss Appropriation A/c	Dr.	3,00,000	
To Capital Redemption Reserve A/c		3,00,000	

(For the amount of profits transferred to Capital Redemption Reserve A/c)

Redeemable Pref. Share Capital A/c Dr. 6,00,000

To Redeemable Pref. Shareholders A/c 6,00,000

(For amount due on redeemable preference shares)

Redeemable Preference Shareholders A/c Dr. 6,00,000

To Bank A/c 6,00,000

(For amount paid to Redeemable Pref. Shareholders)

(ii) Amount of Preference Shares to be redeemed 1,00,000

Less: Amount of Equity shares issued 3,6,000

Amount utilized from P & L A/c 64,000

Bank A/c Dr. 36,000

To Equity Share Application and Allotment A/c 36,000

(For application money received on 4,000 Equity Shares @ Rs. 9 each)

Equity Share Application and Allotment A/c Dr. 36,000

Share Discount A/c Dr. 4000

To Equity Share Capital A/c 4,00,00

(For Transfer of application money on 4000 equity shares @ 9 each)

Profit and Loss Appropriation A/c Dr. 64,000

To Capital Redemption Reserve A/c 64,000

(For the amount of profits transferred to Capital Redemption Reserve A/c)

Redeemable Pref. Share Capital A/c Dr. 1,00,000

To Redeemable Pref. Shareholders A/c 1,00,000

(For amount due on redeemable preference shares)

Redeemable Preference Shareholders A/c Dr. 1,00,000

To Bank A/c 1,00,000

(For amount paid to Redeemable Pref. Shareholders)

(iii) Amount of Preference Shares to be redeemed 80,000

Less: Amount of Equity shares issued 3,0,000

Amount utilised from P & L A/c 50,000

Bank A/c Dr. 30,000

To Equity Share Application and Allotment A/c 30,000

(For application money received on 3,000 Equity Shares @ Rs. 10 each)

Equity Share Application and Allotment A/c Dr. 30,000

To Equity Share Capital A/c 30,0,00

(For Transfer of application money on 3000 equity shares @ 10 each)

Profit and Loss Appropriation A/c Dr. 50,000

To Capital Redemption Reserve A/c 50,000

(For the amount of profits transferred to Capital Redemption Reserve A/c)

Redeemable Pref. Share Capital A/c Dr. 80,000

To Redeemable Pref. Shareholders A/c		800,000
(For amount due on redeemable preference shares)		
Redeemable Preference Shareholders A/c Dr.	800,000	
To Bank A/c		80,000
(For amount paid to Redeemable Pref. Shareholders)		

Summary

In redeemable preference shares, the money received by the company on shares are not refunded till the company is wound up. If approved by its articles, a corporation limited by shares may issue preference shares that must be redeemed or reimbursed after a set length of time. As a result, the funds received on such shares can be refunded over the company's existence. These are known as redeemable preference shares.

Keywords

- Redemption
- Bonus issue of shares
- Capital Redemption reserve
- Premium on Redemption

Self Assessment

1. Tell the security which the public limited company can issue?

A. (a)Equity Share
B. PreferenceShare
C. Debenture
D. All of the above.

2. Where the profit on reissue of forfeited shares is transferred?

A. General Reserve
B. Capital Redemption Reserve
C. Capital Reserve
D. Revenue Reserve

3. Preference shares are those that have preferential rights to ___________?

A. Dividend payment at a fixed rate
B. Capital return at the time of liquidation
C. Both (A) & (B)
D. Either (A) or (B)

4. ___________ will be entitled to dividend arrears?

A. Cumulative Preference Share
B. Non-Cumulative Preference Share
C. Convertible Shares
D. All of these

5. Which of the following rights may be granted to a preference share holder if the Articles provide for it?

A. Participation in surplus profits left after payment of equity dividend

B. Dividend arrears at the time of winding up

C. Premium on redemption of preference shares

D. All of these

6. Which of the following securities can be forfeited for failure to pay allocation or call money?

A. Equity Shares

B. Equity Shares and Preference Shares

C. Equity Shares, Preference Shares, and Debentures

D. Debentures

7. A company limited by shares may, if allowed by its __________, issue preference shares that are or are due to be redeemed?

A. Memorandum of Association

B. Articles of Association

C. Creditors of firm

D. Debtors of company

8. Choose the appropriate option as per which the preference shares can be redeemed?

A. Out of profits

B. From the proceeds of a new issuance of equity shares

C. Both profits and the proceeds of a new issue of equity shares.

D. Any of these

9. Name the category of preference shares that can be redeemed?

A. Partly paid up

B. Fully paid up

C. (A) & (B)

D. None of above

10. If a premium is to be paid on redemption of a preference share, it must be paid from ____?

A. Profits that would otherwise be available for dividend, i.e. free reserve

B. Securities premium A/c

C. (A) or (B)

D. None

11. When preferential shares are redeemed from profits, a payment equivalent to the nominal value of the redeemed shares must be remitted to............?

A. Capital Reserve A/c

B. Capital Redemption Reserve A/c
C. Profit A/c
D. Statutory Reserve A/c

12. The Capital Redemption Reserve Account may be used to issue ___________?
A. Preference shares
B. Debentures
C. Bonus to workers
D. Bonus shares

13. According to the Companies Act of 2013, companies engaged in infrastructure projects can issue preference shares that are redeemable after ___________?
A. 20 yr
B. 40 yr
C. 30 yr
D. 10 yr

14. Redeemable Preference shares can be redeemed using _______________?
A. Investment sale proceeds
B. Proceeds of a fresh issue of shares
C. share premium
D. Revenues of debenture issue

15. Which of the following claims about the redemption of Preference shares is NOT TRUE?
A. Partially paid shares are not redeemable.
B. The redemption of preference shares is treated as a reduction in the authorised share capital of the corporation.
C. Future shares issued for redemption shall not be recognised as an increase in capital.
D. Preference shares can be redeemed using either the profit from capitalization or the amount of new shares issued.

Answer for Self Assessment

1. D	2. B	3. C	4. A	5. D
6. B	7. B	8. D	9. B	10. A
11. B	12. C	13. C	14. B	15. B

Review Questions

1. Define preference shares and its types**?**
2. Procedure for redemption of preference shares?
3. What is the accounting treatment for redemption of preference shares?

4. What for redemption of preference shares?

Further Readings

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Web Links

https://investortonight.com/blog/redemption-of-preference-shares/

Dr. Sachin Kashyap, Lovely Professional University

Unit 04:Redemption of Debenturesand Buyback of Shares

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Meaning and methods of redemption of debentures.
- The accounting treatment for redemption of debentures.
- Meaning and methods of buyback shares.
- The accounting treatment for buyback shares

Introduction

A company's capital is raised by issuing shares. However, the cash raised through the issuance of shares are rarely sufficient to support a company's long-term financial demands. As a result, most corporations turn to debentures to raise long-term finances, which are issued either through private placement or by issuing them to the public. Debenture financing is frequently referred to as long-term debt. This chapter discusses the accounting treatment of debenture redemption, as well as buyback of shares.

Meaning of Debentures

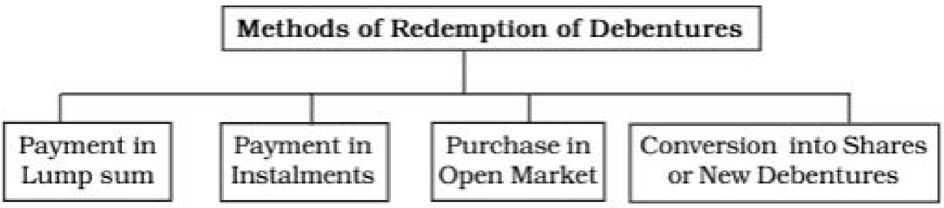
Debenture: The term "debenture" is derived from the Latin word "debere," which means "to borrow." A debenture is a written instrument that acknowledges a debt under the company's common seal. It includes a contract for repayment of principal after a certain period, at intervals, or at the company's discretion, as well as payment of interest at a fixed rate, usually payable half-yearly or yearly on fixed dates. According to Section 2(12) of The Companies Act of 1956, a 'debenture' includes Debenture Inventory, Bonds, and any other securities of a company, whether or not they constitute a charge on the company's assets.

Bond: Bond is also an instrument of acknowledgement of debt. Traditionally, the Government issued bonds, but these days, bonds are also being issued by semi-government and non-governmental organizations. The terms 'debentures' and 'Bonds' are now being used inter-changeably.

4.1 Redemption of Debentures

Extinguishing or discharging the burden on account of debentures in conformity with the terms of issue is referred to as redemption of debentures. In other words, debenture redemption refers to the company repaying the amount of debentures. The debentures can be redeemed in four different ways.

These are as follows:



- Payment in lump amount
- Payment in installments
- Purchase on the open market
- By converting into fresh shares or debentures

4.2 Payment in Lump Sum

The corporation redeems the debentures by paying the whole amount to the debenture holders at the maturity date specified in the terms of issue.

Installment payment: Under this procedure, debentures are often redeemed in installments on the set dates throughout the debenture's lifespan. Divide the entire amount of debenture liability by the number of years. It should be noted that the real redeemable debentures are determined by drawing the required number of lots from the debentures outstanding for payment.

Purchase in open market: When a firm purchases its own debentures for the intention of cancelling them, the act of purchasing and cancelling the debentures constitutes debenture redemption by purchase in open market.

Conversion into shares or new debentures: Debentures can be redeemed by a corporation by converting them into shares or a new class of debentures. If debenture holders believe the offer is advantageous, they may exercise their entitlement to convert their debentures into shares or a new class of debentures. These new shares or debentures may be issued at face value, a discount, or a premium. It should be emphasized that only the actual proceeds of debentures are to be considered when determining the number of shares to be issued in lieu of the converted debentures. If debentures were originally issued at discount, the actual amount realized from them at the time of issue would be used as the basis for computing the actual number of shares to be issued. It may be noted that this method is applicable only to convertible debentures.

Redemption by Lump Sum Payment- When the company pays the entire amount in one lump sum, the following journal entries are entered in the company's books:

1. If debentures are to be redeemed at par

(Debentures A/c

To Debenture holders

Debenture holders

To Bank A/c

2. If debentures are to be redeemed at premium

Debentures A/c

Premium on Redemption of Debentures A/c

To Debenture holders

Debenture holders

To Bank A/c

Example –

In each of the following cases, make the relevant journal entries at the time of debenture redemption.

1. PQ Ltd. issued 5,000 9 percent debentures of Rs 100 each at par, redeemable at par at the end of 5 years.

2. PQ Ltd. issued 1,000 12% debentures at Rs 100 each at par. These debentures are redeemable after four years at a 10% premium.

3. PQ Ltd. issued 12% debentures with a total face value of Rs 1,000,000 at a 5% premium to be repaid at par after 4 years.

4. PQ Ltd. issued Rs 1,00,000 in 12 percent debentures at a 5% discount but redeemable at a 5% premium at the end of 5 years.

Solution - Journal

1.	9% Debentures A/c	Dr.	5,00,000	
	To Debentureholders A/c			5,00,000
	(Amount due on redemption debentures)			
	Debentureholders A/c	Dr.	5,00,000	
	To Bank A/c			5,00,000
	(Payment made to debentureholders)			
2.	12% Debentures A/c	Dr.	1,00,000	
	Premium on Redemption of Debentures A/c	Dr.	10,000	
	To DebentureholdeRs			1,10,000
	(Amount due on redemption of debentures)			
	Debentureholders A/c	Dr.	1,10,000	
	To Bank A/c			1,10,000
	(Payment made to debentureholders)			
3.	12% Debentures A/c	Dr.	1,00,000	
	To Debentureholders A/c			1,00,000
	(Amount due on redemption)			
	Debentureholders A/c	Dr.	1,00,000	
	To Bank A/c			1,00,000
	(Payment made to debentureholders)			
4.	12% Debentures A/c	Dr.	1,00,000	
	Premium on Redemption of Debentures A/c	Dr.	5,000	
	To Debentureholders A/c			1,05,000
	(Amount due on redemption of debentures)			
	Debentureholders A/c	Dr.	1,05,000	
	To Bank A/c			1,05,000
	(Payment made to debentureholders)			

According to the provisions of the Companies Act of 1956, the company must set aside a percentage of its income each year and transfer it to the Debenture Redemption Reserve for debenture redemption until the debentures are redeemed.

Section 117C of the Companies Act of 1956 states that (as amended in 2000)-

(a) If a company issues debentures after the effective date of this Act, it shall establish a Debenture Redemption Reserve for the redemption of such debentures, to which an adequate sum shall be credited each year until such debentures are redeemed.

(b) The sum credited to the Debenture Redemption Reserve shall not be used by the corporation for any purpose other than debenture redemption.

SEBI Guidelines-

The Securities and Exchange Board of India (SEBI) has established guidelines for debenture redemption. The following are the key points of these guidelines:

- Every corporation must establish a Debenture Redemption Reserve if it issues a debenturethat is redeemable after more than 18 months from the date of issue.
- Only nonconvertible debentures and nonconvertible portions of partly convertible debentures are required to establish a Debenture Redemption Reserve.
- Before beginning the redemption of debentures, a firm must establish a Debenture Redemption Reserve equal to at least 50% of the debenture issue amount.

- Withdrawals from the Debenture Redemption Reserve are permitted only once the corporation has decreased 10% of the debenture liability.

SEBI standards would not apply in the following cases:

(a) An infrastructure company (a firm wholly involved in the business of creating, maintaining, and running infrastructure facilities); and

(b) a company issuing debentures with a maturity period of less than 18 months.

Clarifications on the establishment of the Debenture Redemption Reserve(DRR)-

In Circular No.9/2002, dated 18.04.2002, the Department of Company Affairs of the Government of India issued the following clarifications about the establishment of the Debenture Redemption Reserve (DRR):

(a) Debentures issued by All India Financial Institutions regulated by the RBI and Banking Companies, both publicly and privately listed, do not require DRR.

(b) No DRR is required for privately placed debentures.

(c) Because Section 117C applies to debentures issued and pending redemption, DRR will be generated for debentures issued before to 13.12.2000 and pending redemption.

(d) Section 117C applies to the non-convertible portion of debentures issued, whether fully or partially paid. The Debenture Redemption Reserve account is listed under "Reserves and Surpluses" on the liability side of the Balance sheet. When debentures are redeemed, the corresponding amount of Debenture Redemption Reserve is transferred to General Reserve.

4.3 Payment in Installments for Redemption

When the debentures are to be redeemed in installments commencing from a specific year, the actual debentures to be redeemed are normally chosen by lot, and the redemption might be made from profits or from capital. The following entries will be:

1. If redeemed out of profits

(a) Statement of profit and loss

To Debenture Redemption Reserve A/c

(b) Debentures A/c

To Debenture holders

Debentureholders

To Bank A/c

2. If redeemed out of capital

(a) Debentures A/c

To Debenture holders

(b) Debenture holders

To Bank A/c

4.4 Redemption by Purchase in Open Market

When a corporation buys its own debentures in the open market with the intention of cancelling them immediately, the transaction is known as redemption by purchase in the open market. The advantage of this option is that a corporation can redeem the debentures whenever it has excess funds. Secondly, the corporation can purchase them when they are for sale in the market.

When debentures are obtained at a discount from the market and cancelled, the following journal entries are made:

1.On purchase of own debentures for immediate cancellation

Debentures A/cDr.

To Bank A/c To Profit on Redemption of Debentures A/c

2.On transfer of Profit on Redemption

Profit on Redemption of Debenture A/cDr.

To Capital Reserve

In case, the debentures are purchased from the market at a price which is above the nominal value of debenture, the excess will be debited to loss on redemption of debentures. The journal entry in that case will be

Debentures A/c

Loss on Redemption of Debentures A/c

To Bank A/c

Statement of profit and loss

To Loss on Redemption of Debentures A/c

Example- Dr. MR Ltd. purchased Rs 100 debentures with a face value, of Rs 20,000 on the open market for cancellation for Rs 92.

Make any required journal entries.

Books of MR Limited

Debentures A/c Dr. 20,000

To Bank A/c 18,400

To Profit on Redemption of Debentures A/c 1,600

(Own debentures purchased at Rs 92 from the market)

Profit on Redemption of Debenture A/c 1,600

To Capital Reserve 1,600

(Transfer of profit on cancellation of debentures to capital reserve)

4.5 Redemption through Conversion

As previously noted, debentures can be redeemed by changing them into shares or fresh debentures. If debenture holders believe the offer is advantageous to them, they will take advantage of it. The new shares or debentures might be issued at face value, a discount, or a premium. It should be noted that convertible debentures do not require a Debenture Redemption Reserve because no money is required for redemption.

4.6 Sinking Fund Method

To redeem debentures at the end of a defined time, sufficient funds must be available. To achieve this criteria, the corporation may elect to establish a sinking fund and invest a sufficient amount in marketable securities or bonds issued by other businesses. Typically, a corporation ensures that an equal amount is placed away each year to ensure that the appropriate funds are available at the time of redemption. This is known as the Sinking Fund approach, in which the corporation makes the required procedures to set aside a portion of its profit each year and invest it outside the business in marketable securities.

The Sinking Fund Table is used to compute an appropriate amount based on the rate of return on investments and the number of years for which investments are made. Every year, the amount determined is transferred from profits to the Debenture Redemption Fund, and its investment is known as Debenture Redemption Fund Investment. These investments generate a set amount of income (called interest) that is reinvested along with the fixed amount allowed for the purpose in succeeding years. The interest earned and the appropriated fixed sum were not invested last year. In fact, at this point, the Debenture Redemption Fund Investments are cashed, and the proceeds are utilized to redeem debentures. Any profit or loss realised from the redemption of Debenture Redemption Fund investments is likewise transferred to the Debenture Redemption Fund Account. The formation of the Debenture Redemption Fund Account fulfils the function of the Debenture Redemption Reserve as required by law and the SEBI rules, and is transferred to general reserve after redemption.

Thus, the steps involved in the operation of the sinking fund method are as follows:

1. Using the sinking fund chart, calculate the amount of profit to be set aside annually.

2. At the conclusion of each year, set aside the amount of profit and credit it to the Debenture Redemption Fund (DRF) Account.

3. At the end of the first year, purchase the equivalent amount of investments and debit the Debenture Redemption Fund Investment (DRFI) Account.

4. Receive interest on your investment at the end of each year.

5. Acquisition of investments equal to the fixed amount of profit set aside and the interest earned every year except last year (year of redemption).

6. Receive interest on your investment for the previous year.

7. Set away a certain amount of profit from the previous year.

8. Cash out the investments at the conclusion of the redemption year.

9. Transfer the profit/loss on investment sales shown in the Debenture Redemption Fund Investment Account balance to the Debenture Redemption Fund Account.

10. Payment to the debenture holders

11. Transfer the balance of the Debenture Redemption Fund A/c to the General Reserve.

The sinking fund technique is utilized for debenture redemption by lump sum payment on maturity, and the journal passed from year to year is as follows:

1. At the end of First Year

(a) For setting aside the fixed amount of profit for redemption

Statement of profit and loss

To Debenture Redemption Fund A/c

(b) For investing the amount set aside for redemption

Debenture Redemption Fund Investment A/c

To Bank A/c Dr. Dr.

2. At the end of second year and subsequent years other than last year

(a) For receipt of interest on Debenture Redemption Fund Investments

Bank A/c Dr.

To Interest on Debenture Redemption A/c

Fund Investment A/c

(b) For transfer of Interest on Debenture Redemption Fund Investment to Debenture Redemption Fund Account

Interest on Debenture Redemption Fund Investment A/c Dr.

To Debenture Redemption Fund A/c

(c) For setting aside the fixed amount of profit for redemption

Statement of profit and loss

To Debenture Redemption Fund A/c Dr.

(d) For investments of the amount set aside for redemption and the interest earned on DRFI

Debenture Redemption Fund Investment A/c

To Bank A/c

3. At the end of last year

(a) For receipt of interest

Bank A/c

To Interest on Debenture Redemption Fund Investment A/c Dr.

(b) For transfer of interest on Debenture Redemption Fund Investment to Debenture Redemption Fund Investment A/c

Interest on Debenture Redemption Fund Investment A/c Dr.

To Debenture Redemption Fund A/c

(c) For setting aside the fixed amount of profit for redemption

Statement of profit and loss

To Debenture Redemption Fund A/c Dr.

(d) For encashment of Debenture Redemption Fund Investments

Bank A/c Dr.

To Debenture Redemption Fund Investment A/c

(e) For the transfer of profit/loss on realization of Debenture Redemption Fund Investments

(i) In case of Profit

Debenture Redemption Fund Investment A/c

To Debenture Redemption Fund A/c

Or

In case of Loss

Debenture Redemption Fund A/c

To Debenture Redemption Fund Investment A/c

For amount due to debentureholders on redemption

Debenture A/c

To Debenture holders A/c

(g) For payment to debenture holders

Debenture holders A/c

To Bank A/c.

(h) For transfer of Debenture Redemption Fund Account balance to General Reserve

Debenture Redemption Fund A/c

To General Reserve A/c

4.7 Buyback of Shares

Share buybacks is a way for cancellation of share capital. It results in a decrease in a company's share capital as opposed to an increase in share capital through the issuance of shares. The corporation may consider a repurchase if the following conditions are met:-

- The company has exhausted all potential sources of new investment in the near future.

- A buyback can be carried out without putting the lender's risk at danger.
- The corporation benefits from a return on capital employed that is much higher than the typical cost of borrowing.
- The market price of the company's stock is significantly lower than its true worth.

4.8 Regulation of Share Buybacks in the Indian Context

A business may purchase its own shares from:

1. Its free reserves;

2. The securities premium account; or

3. The proceeds of any shares or other specified securities, according to Section 77A(1) of the Companies (Amendment) Act 1999.

Section 77A (2) sets the following conditions for buyback- No corporation shall purchase its own shares or other specified securities unless and until the following conditions are met:

1. The buyback is authorized by the Articles of Association.

2. A special resolution authorizing the buyback must be passed in the company's general meeting.

3. The buyback is for less than 25% of the company's total capital considering paid up capital and free reserves.

4. The company's debt-to-capital ratio is not more than twice the capital and free reserves following the buyback.

5. All of the shares or other specified securities for repurchase have been fully paid up.

6. The repurchase securities must be listed on any stock exchange in line with the Securities and Exchange Board of India's regulations in this regard.

Every buyback must be completed within 12 months of the day the special resolution was passed, according to section 77A (4).

Section 77A (5) allows for the following buybacks:

1. Proportionately from existing security holders; or

2. From the open market; or

3. From odd lots, the shares listed on the stock exchange.

4. Bypurchasing securities offered to corporate employees under a stock option arrangement.

According to Section 77A(6), if a company has approved a special resolution to buyback, it must file a declaration of solvency in the form provided by the board with the registrar and the SEBI before proceeding with the buyback.

Section 77A(7) requires a firm that buys back its own stock to extinguish and physically destroy the securities purchased within seven days of the latest date of completion of the buyback.

Section 77A (8) states that after a business completes a share buyback, it cannot issue the same type of shares again for 24 months, unless it is a bonus issue.

According to Section 77B, no corporation may purchase its shares:

1. Through any subsidiary company, including its own subsidiary companies; or

2. through any investment firm.

Section 77AA requires a firm that purchases its own shares from free reserves to transfer an amount equal to the nominal worth of the shares purchased back to the Capital Redemption reserve account from free reserves.

SEBI GUIDELINES.

SEBI issued the following regulations in 1998-

Buybacks cannot be made from any person through negotiated proceedings, whether on or after the stock exchange, through spot transactions, or through private management.

Among other things, a public statement should include the following information:

- Specified date, i.e. the date of delivery of the offer letter must be within 30 days but no later than 42 days.
- The company must notify SEBI within 7 working days on the date of the public announcement.
- The buyback offer shall be accessible to members for a period of not less than 15 days and not more than 30 days.
- Within 15 days of the date of closing, the corporation must complete the verification of bids.
- Companies may repurchase shares through six channels: tender, open offer, reverse book building, odd lot share purchase, reverse rights, and employee stock option purchase.

Advantages of buyback.

- A buyback allows a corporation to reduce surplus share capital that is no longer required.
- It assists the company in making use of its significant amount of free reserves.
- It assists the company in improving its book value, earnings per share, price-to-earnings ratio, and return on equity.
- Corporations may repurchase their own shares to shield themselves from hostile takeovers by other companies.
- Buybacks are a relatively quick way to reduce share capital. It is a lower-cost transaction.
- If a corporation has a significant amount of cash and is unsure how to invest it, one option is to distribute a portion of it to the shareholders. Companies can do this in two ways: a) through dividends or b) by purchasing outstanding shares.

Limitations of buyback

- Strict legal requirements.
- Reductionin cash surplus with the company.
- Fear of price manipulation in the stock market.
- It has the potential to divert funds away from profitable projects.
- The debt equity ratio after the repurchase must not exceed 2:1.
- The maximum number of equity shares returned should not exceed 25% of the current paid-up capital.

4.9 Accounting Entries in Buyback of Shares

The following entries may be required to record buyback of shares:-

a)When investments are sold for buyback of own shares:-

Bank a/c Dr

Profit & loss a/c Dr(for loss on sale of investment)

To Investment a/c

To Capital Reserve a/c(for the profit on sale of investments)

b) For issue of debentures/other specified securities for buyback purpose:-

Bank a/c Dr

To Debentures/other Specified Security a/c

To Securities Premium a\c(if any)

c) For cancellation of shares bought back:-

Equity Share Capital a/c Dr(with nominal value of shares buyback)

Free Reserves/Securities Premium a\c Dr

To Shareholders a/c(with actual cost of buyback shares)

d)For making the payment of buyback shares:-

Shareholders a/c

To Bank a/c Dr

e)For transfer of nominal value of shares bought back out of free reserves:-

Free reserves a/c Dr

To Capital Redemption Reserve a/c

f)For expenses incurred in buyback of shares:-

Buyback expenses a/c

To Bank a/c Dr

g)For transfer of buyback of expenses:-

Profit & Loss a\c Dr

To Buyback expenses a/c

Summary

Thus, it can be stated that Indian corporations announce buybacks in response to their stocks' undervaluation in capital markets, and they are well backed by the availability of sufficient cash balance for the same. Thus, on the one hand, the premium offered in terms of declared repurchase prices provides an exit option for shareholders, while on the other hand, it provides an opportunity for the company to use its liquidity position to extinguish its shares now and reissue them later. It prevents takeoversand mergers, hence preventing monopolization and ensuring consumer sovereignty's survival. On the other hand, buybacks can help inflating share prices by manipulating the records. Earnings per share, Price-Earnings Ratio, therefore misleading shareholders As a result, understanding the effects of buybacks becomes critical, and every shareholder should reassess his or her position before purchasing shares in companies involved in the buyback process.

Keywords

- Redemption of Debentures
- Methodsredemption of Debentures
- Buyback of shares
- Accounting treatment for buyback of shares

Self Assessment

1. Tell whether debenture is a part of owned debt?

A. True

B. False

2. Redeemable debentures are to be paid on the expiration of the definite period.
A. True
B. False

3. The premium on redemption of debentures account is reflected in the balance statement under 'Securities Premium.'
A. True
B. False

4. Where the balance in the debentures redemption fund is moved at the time of redemption of debentures?
A. capital reserve
B. General reserve
C. Reserve & Surplus statement
D. None

5. What are Own debentures?
A. Allocated to its own promoters
B. Issued its director, or both.
C. The corporation buys from the market and keeps the proceeds as an investment.
D. None

6. Where profit on cancellation of own debentures is move to?
A. Statement of profit and loss
B. Debenture redemption reserve
C. Capital reserve
D. None

7. What will be the profit on investment sale if the nominal and book values of the debenture redemption fund investments account are Rs 1,000,000 and Rs 96,000, respectively. The corporation sold investments with a nominal value of Rs 30,000 at a price that was just enough to redeem debentures with a nominal value of Rs 30,000 at a 10% premium.
A. Rs 4,200
B. Rs 3,000
C. Rs 4000
D. Nil

8. Where does profit on the sale of debenture redemption fund investments is initially credited to?
A. Debenture redemption fund account
B. Statement of profit and loss
C. General reserve account
D. None

9. After the realization of investments, where does the balance of sinking fund investment account is transferred?
A. Sinking fund account
B. Statement of profit and loss
C. General reserve account
D. None

10. Name the account to be credited in case of transfer of interest on Sinking fund investments to sinking fund account.
A. Sinking fund account
B. Statement of profit and loss
C. General reserve account
D. None

11. Name the account to be credited in case of Profit on sale of sinking fund investment account.
A. Sinking fund account
B. Statement of profit and loss
C. c) General reserve account
D. d) Loss on Issue of Debentures Account

12. The amount as per _________ should be included, when calculating the limit of capital and reserve.
A. Profit and Loss Statement
B. Most Recent Balance Sheet
C. None of the above
D. General reserve account

13. The debt–equity ratio after the buyback should not be greater than ___________?
A. 02:02
B. 01:02
C. 01:01
D. 02:01

14. Shares can be repurchased in the form of ____________ fully paid up shares.
A. Entirely subscribed
B. Partially subscribed
C. Fully subscribed
D. None

15. To provide funds for the buyback, the company should open a___________ Account with a bank.
A. Fixed deposit

B. Savings account
C. Current account
D. Escrow

Answer for Self Assessment

1.	A	2.	A	3.	B	4.	B	5.	C
6.	C	7.	A	8.	C	9.	A	10.	A
11.	D	12.	B	13.	D	14.	A	15.	D

Review Questions

1. Explain the various methods of redemption of Debentures**?**
2. What is Sinking Fund? Explain the accounting treatment for preparation of Debenture Sinking fund?
3. Define Buyback of shares and the accounting treatment for buyback of shares?
4. Explain the SEBI guidelines, advantages and disadvantages for buyback of shares?
5. On January 1, 2012, X Ltd. issued Rs 10,00,000 debentures. These were set to expire on December 31, 2014. The corporation formed a sinking fund for this reason. The investments were intended to earn interest at a rate of 5% per year. According to the sinking fund table, Rs 0.317208 invested annually at 5% yields Rs.1 in three years. Before receiving interest on Sinking Fund Investments, the bank balance on December 31, 2014 was Rs 4,20,000. The investments were sold for Rs 6,56,00 on that date. Calculate the interest to the nearest rupee and make investments to the nearest Rs 100. Make any required journal entries. Display the Debentures Account, Debenture Redemption Fund Account, and Debenture Redemption Fund Investment Account in the company's books.

Further Readings

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Unit 05: Underwriting of Shares & Managerial Remuneration

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- meaning and methods of underwriting of shares.
- the accounting treatment for underwriting of shares.
- types of underwriting of shares.
- learn the mode of payment of managerial remuneration.
- know the overall ceiling including individual ceilings on managerial remuneration.
- describe the position about payment of managerial remuneration in a year the company makes a loss or has inadequate profits.

Introduction

Underwriting is a conditional or unconditional agreement to subscribe to a company's securities when current shareholders or the general public do not subscribe to the securities offered to them. An underwriting agreement is a contract between an underwriting group or syndicate of investment bankers and the issuing corporation of a new securities issue. It is an arrangement between a corporation and an individual or group of individuals to give a guarantee that if shares or debentures are not fully subscribed by the public, the firm would purchase the remaining shares and debentures. When a company makes an initial public offering (IPO), it may confront some uncertainty regarding whether or not its offer of shares or other instruments will be fully subscribed. According to SEBI Guidelines 14(4)(b), if the firm is unable to collect 90 percent of the offer amount, it is compelled to return the money to individuals who have subscribed to the shares, causing a lot of issue expenses to go to waste.

5.1 Underwriting commission

The amount paid to the underwriter in exchange for a share or debenture issued by a firm is referred to as the underwriter commission. Underwriting commission is a payment made by the company to underwriters in exchange for their underwriting services. Companies can charge underwriters a maximum of 5% commission when selling their shares.

PAYMENT OF UNDERWRITING COMMISSION - Under Section 76 of the Companies Act of 1956, a firm may pay such commission subject to the following restrictions:

- The payment of commission must be authorized in the articles.
- The rate of commission cannot exceed 5% of the issue price of shares or the amount or rate approved by the articles, whichever is less, and 2.5 percent of the issue price or the amount or rate authorized by the articles, whichever is less, in the case of debentures.
- In fact, SEBI has only permitted a commission of 2.5 percent of the issue price of equity shares, despite Section 76's maximum rate of 5 percent.
- The commission paid or promised to be paid must be declared in the prospectus, or in the statement in lieu of prospectus if no prospectus is provided.
- The prospectus should include the number of shares or debentures to which underwriters have agreed to subscribe unconditionally or conditionally.
- A copy of the commission payment contract should be given to the registrar.
- If the shares or debentures are offered to the general public, then the commission is payable. If the issue is privately placed, no underwriting commission can be paid.

Underwriting is not compulsory as per SEBI norms. If the issue is not underwritten and a minimum subscription of 90% of the offer to the public is not received, the entire amount received as subscription must be repaid in full. If the offer is underwritten and the firm does not receive 90 percent of the issued capital from public subscription plus acceptable development from underwriters within 120 days of the issue's opening, the company must refund the subscription amount.

The lead managers must satisfy themselves about the underwriters' net worth and ongoing commitments and submit the same to SEBI. The underwriter's agreement may be disclosed with the stock market. The following underwriting commission payment rates are in effect.

Nature of issue	Amount devolving on underwriter	Amount subscribed by public
1.Equity share	2.5%	2.5%
2. Preference share/ debentures		
a. issue amount up to ? 500000	2.5%	1.5%
b.issue amount exciding ? 500000	2%	1%

5.2 Advantages of Underwriting

- It absolves the corporation of the risk and uncertainty associated with marketing the securities.
- Underwriters are intimately and skilled in the capital market. They provide significant guidance to the issuing firm in the drafting of the prospectus, the timing of the floating, and so on.
- It increases investor confidence in the issuance of securities and assures the issuing company of the availability of money. Important initiatives are not postponed due to a lack of finances.

- They also give publicity services to firms with which they have underwriting agreements.

5.3 Underwriting Types

- Complete underwriting—Complete underwriting occurs when a company's whole issue of shares or debentures is underwritten.
- Partial underwriting-Partial underwriting occurs when a portion of a company's share or debenture offering is underwritten.
- Firm underwriting occurs when an underwriter agrees to purchase a certain number of shares or debentures in addition to the shares and debentures required by the underwriting agreement.
- Partial underwriting in conjunction with firm underwriting-In this type of underwriting, the individual underwriter does not benefit from firm underwriting in determining the number of shares or debentures to be purchased.

5.4 Disclosure Requirements (Provisions of the Companies Act, 1956 Regarding Disclosure of Underwriting Agreement)

- Disclosure in the Prospectus.
- Disclosure in the Statutory Report.
- Disclosure of Sums Payable.

Practical solved examples-

Partial Underwriting

A corporation issued 100,000 shares at a price of $100 per share. The following shares were underwritten:

X - 30,000 shares

Y- 50,000 shares

70,000 shares were applied for by the general public.

Determine the liabilities of X, Y, and the company.

Answer

The problem does not include any marked programmes. As a result, applications are credited to underwriters, including the corporation, on a gross liability basis. For 20,000 shares, the corporation should be recognized as an underwriter.

	X	Y	Company	Total
Gross Liability	30,000	50,000	20,000	100,000
Less: Application received in the ratio of 30:50:20	21,000	35,000	14,000	70,000
Net Liability	9,000	15,000	6,000	30,000

Alternatively, the calculations can be made as follows:

Unsubscribed shares = 100,000 - 70,000 = 30,000

Thus the net liability of	X	= 30,000 x 30/100	= 9,000 shares
	Y	= 30,000 x 50/100	= 15,000 shares
	Company	= 30,000 x 20/100	= 6,000 shares

Full Underwriting

A firm founded on January 1, 2019, issued a prospectus requesting applications for 500,000 equity shares at $10 per share. The entire issue was totally underwritten by four underwriters, as noted below:

- A: 200,000 shares; B: 150,000 shares; C: 100,000 shares; and D: 50,000 shares.

Applications for 450,000 shares were received, with the following noted applications:

A: 220,000 shares; B: 90,000 shares; C: 110,000 shares; and D: 10,000 shares.

Determine the liability of individual underwriters.

Solution-

	A	B	C	D	Total
Number of shares underwritten	200,000	150,000	100,000	50,000	500,000
Less: Credit for unmarked forms (20 : 15 : 10 : 5)	8,000	6,000	4,000	2,000	20,000
Liability after the credit of unmarked forms	192,000	144,000	96,000	48,000	480,000
Less: Relief for marked forms	220,000	90,000	110,000	10,000	430,000
Resultant liability	-28,000	54,000	-14,000	38,000	50,000
Division of surplus of A and C to B and D in 15 : 5 ratio (i.e., 28,000 + 14,000 = 42,000)	+28,000	-31,000	+14,000	-10,500	-
Net Liability	**Nil**	**22,500**	**Nil**	**27,500**	**50,000**

Number of unmarked applications = Total Shares applied for - Marked applications

= 4,50,000 - 4,30,000 = 20,000 shares

Note- It is not required to distinguish between marked and unmarked applications when the entire issue is underwritten by a single underwriter. In this situation, the underwriter's responsibility would be 50,000 shares.

Firm Underwriting-

John Limited issued 10,000 shares(units), each worth $100. The following persons underwrote the entire issue:

- A: fifty percent
- B: Thirty percent
- C: Twenty percent

Furthermore, there was firm underwriting as follows:

- A: 1,000 units
- B: 750 units
- C: 500 units

8,000 shares were subscribed for in total, including firm underwriting. The subscription included the marked applications listed below:

- A: 1 500 units
- B: 2,000 units
- C: 750 units

Calculate the underwriters' liability as required.

Solution-

	A	B	C	Total
Gross Liability	5,000	3,000	2,000	10,000
Less: Credit for unmarked forms (8,000 - 4,250) in 5 : 3 : 2	1,875	1,125	750	3,750
	3,125	1,875	1,250	6,250
Less: Relief for marked forms	1,500	2,000	750	4,250
	1,625	-125	500	2,000
Less: Division of surplus of B to A and C in 5 : 2	-89	+125	-36	
	1,536	-	464	2,000
Add: Firm underwriting	1,000	750	500	2,250
Net Liability	2,536	750	964	4,250

Q. A corporation issued a prospectus in which it invited applications for 20,000 equity shares at a price of $100 per share. The entire issue was fully underwritten by three underwriters, who are listed below:

- A: ten thousand shares
- B: seven thousand shares
- C: three thousand shares

Applications for 16,000 shares were received, including the following indicated applications:

- 7 600 shares
- 4 040 shares
- C (3,360 shares)

Required: Show how the underwriting liability should be completed.

Solution-

	A	B	C	Total
Shares underwritten	10,000	7,000	3,000	20,000
Less: Credit for direct applications (16,000 - 15,000) in 10 : 7 : 3	500	350	150	1,000
	9,500	6,650	2,850	19,000
Less: Relief for personal performance	7,600	4,040	3,360	15,000
	1,900	2,610	-510	4,000
Less: Surplus of C distributed to A and B in 10 : 7	-300	-210	+510	-
Final Liability	1,600	2,400	-	4,000

5.5 Accounting Treatment for Under Writing in the books of Company and Underwriters

Following entries will be passed on in the books of company for underwriting:

(i) For Under Writing Commission :
Underwriting Commission A/c Dr.
To Underwriter's A/c
(Underwriting commission due to underwriters.)

(ii) Issue of Balance Shares to Underwriters

Underwriter's A/c Dr.
To Equity Share Capital A/c
(Shares allotted to underwriters under underwriting agreement)

(iii) Receive Final Payment :

Bank A/c Dr.
To Underwriter's A/c
(Final payment received from underwriters)

Note : If there is no liability of underwriter to purchase shares or Amount of commission exceeds amount of gross liability, then Following entry will be passed:-

(iv) For making Final Payment.

Underwriter's A/c Dr.
To Bank A/c
(Final payment made to underwriter.)
(v)For write off Commission Account :
Reserve/Securities Premium/ P&L A/c Dr.
To underwriting commission A/c (Commission Account written off)

Accounting Treatment in the Books of Underwriter:

Journal Entries :

(1) For Underwriting Commission:

X Company A/c Dr.
To Underwriting Commission A/c
(Commission due from X Company)

(2) For Share Received From Company :

Shares/Debentures (Investment) in X Company A/c Dr.
To X Company A/c (at issue price only)

(Balance shares received from X Company)

(3) Transfer Commission into Share Account :

Underwriting Commission A/c Dr.
To Shares/Debentures (Investment) A/c
(Commission transferred into shares account)

(4) Making final Payment :

X Company A/c Dr.
To Bank A/c
(Final payment made to company)

(5) When Underwriters are not Liable to take Shares and Commission is Received :

Bank A/c Dr.

To X Company A/c

(Commission received from Company)

Note: If amount payable on shares is less than commission then A lso this entry will be passed for the balance of amount.

(6) : To Close Commission A/c when it is not Transferred to Share A/c
P&L A/c Dr.
To Underwriting Commission A/c
(Commission transferred to P&L A/c) Easy to Understand the concept

5.6 Managerial Remuneration

Managerial remuneration can take the form of monthly payments, such as a salary, or a defined percentage of net profits or a commission, and/or a charge for each Board meeting (called sitting fee). Section 2(78) defines "remuneration" as any money or its equivalent given or passed to any person in exchange for services rendered, including perquisites as defined by the Income-tax Act of 1961. Explanation VI B to Schedule V adds that "remuneration" includes repayment of any direct taxes paid to the management person. Section 197(3) states that where a company obtains insurance on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer, or Company Secretary to indemnify any of them against any liability arising from any negligence, default, misfeasance, breach of duty, or breach of trust in relation to the company, the premium paid on such insurance is not treated as part of the remuneration. However, if such a person is found to be guilty, the premium paid for such insurance will be considered part of the punishment.

WHAT IS NOT MANAGERIAL REMUNERATION? Following are not included in managerial remuneration-

- Any insurance premium paid on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer, or Company Secretary to indemnify any of them against any liability arising from any negligence, default, misfeasance, breach of duty, or breach of trust in relation to the company. However, if such a person is found to be guilty, the premium paid on such insurance is considered part of the payment [Section 197(3)].
- Any remuneration for services rendered by any director in any other capacity shall not be so included if—a) the services rendered are of a professional nature; and b) the director possesses the requisite qualification for the practise of the profession in the opinion of the Nomination and Remuneration Committee, if the company has such a Committee as per section 178, or the Board of Directors in other cases [Section 197(4)].
- SuessenTextile Bearings Ltd. v. Union of India [1984] The Court noted that the Guarantee Commission received by the director is for personal obligation assumed by the director. As a result, guarantee commission is not payment under Section 197. (corresponding to section 309 of the previous Act)

5.7 Payment Methods

A director or management may be compensated in the following ways:

- monthly payment*;
- specific percentage of net profit; or
- partially by one method and partly by another.

In addition, he may be paid a sitting fee for attending Board meetings. An independent director may be compensated by sitting fees, reimbursement of expenses for participation in Board meetings and other meetings, and profit-related commissions granted by the members.

Sitting Fees: The amount of sitting fees payable to a director, as already mentioned, shall not exceed the statutory amount. Rule 4 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 established a limit of one lakh rupees every meeting of the Board or its committee. The Act makes no mention of a sitting charge. It refers to the charge paid to a director for attending a Board or Committee meeting.

Overall Limit The entire managerial remuneration payable by a public company to its directors, including managing directors and full-time directors, and its manager in any fiscal year must not exceed 11% of the company's net earnings for that fiscal year [Section 197 (1)].

MANAGERIAL REMUNERATION INDIVIDUAL CEILING- Section 197 states that, except with the approval of the company by a special resolution in general meeting,

i) the remuneration payable to any one managing director; or whole-time director or manager shall not exceed 5% of the company's net profits, and if there is more than one such director, remuneration shall not exceed 10% of the net profits to all such directors and managers combined;

ii)the remuneration payable to directors who are not managing or full-time directors shall not exceed:

a)1% of the company's net profits if the company has a managing or full-time director or manager;

b)3% of the company's net profits in all other cases.

Private enterprises are given exemption from the aforementioned Sec. 197 ceilings.

Remuneration provided to a Director in a Professional Role – Remuneration for services rendered by any director in any other capacity is not included if

(a) the services rendered are of a professional nature; and

(b) the director possesses the requisite qualification for the practise of the profession in the opinion of the Nomination and Remuneration Committee, if the company has such a Committee as per Section 178, or the Board of Directors in other cases [Section 197(4)].

Additional Remuneration from Subsidiary Company- Section 197 provides that any director who is receiving a commission and is a managing or whole-time director of a company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company, subject to the company disclosing it in the Board's report.

EXCESS PAID REMUNERATION-

If a director draws or gets any sum as salary in excess of the limits stipulated in section 197 or without the prior authorization of the Central Government, he must refund it within two years. He must maintain the extra cash in trust for the firm until he refunds it to the company [Section 197(9)]. Furthermore, unless authorized by the Central Government, the corporation cannot waive its recovery.

5.8 ManagerialRemuneration vis-à-vis Schedule v

Part II of Schedule V allows a public business to appoint a managing or whole-time director or management and establish their salary in accordance with the conditions set out in Schedule V without requesting prior approval from the Central Government.

The following are the highlights of Schedule V:

Section I: Payment payable by profit-making firms - A profit-making company may pay salary to a managerial person or individuals up to the restrictions stated in section 197 [Already mentioned under 'Individual ceilings on managerial remuneration']. Section II: Remuneration payable by companies with no profits or insufficient profits - If a company has no profits or insufficient profits in any fiscal year, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits set out in (A) and (B) below*.

a) Where a company's effective yearly remuneration capital is:

i) Negative or less than 5 crores	30 lakhs
ii) 5 crores and above but less 100 crores	84 lakhs
iii) 100 crores and above but less than 250 crores	120 lakhs

iv) 250 crores and above	120 lakhs plus 0.01% of the effective capital in excess of Rs. 250 crores

b) In the case of a managerial person who was not:

I) a security holder holding securities of the company with a nominal value of Rs. 5 lakh or more;

II) an employee;

III) a director of the company or related to any director or promoter at any time during the two years preceding his appointment as a managerial person — 2.5 percent of the current relevant profit.

However, in order to pay a manager's remuneration within the aforementioned ceiling limits, it has been made obligatory that:

I) payment of remuneration is approved by a resolution passed by the Board and, if a company has a Nomination and Remuneration Committee, also by the Nomination and Remuneration Committee; and

II) the company has not defaulted in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding fiscal year before the date of appointment of such managerial person.

Schedule V allows enterprises to pay their manages up to twice the amount of the aforementioned ceiling by following the above-mentioned procedure and making a special resolution at the general meeting that is valid for three years.

Section III The following companies may pay to a managerial employee up to twice the amount permitted under Section II without the consent of the Central Government:

a) A foreign company with the approval of its shareholders in general meeting, subject to the restrictions set forth in Section 197.

b) A newly formed firm for a term of seven years from the date of formation.

c) A sick company for a term of five years from the date of approval of the revival strategy.

d) A company in a Special Economic Zone as notified by the Department of Commerce from time to time that has not raised any money in India by public issue of shares or debentures, and has not defaulted in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in any fiscal year, may pay remuneration of up to Rs. 2,40,00,000 per annum.

Besides the aforementioned salary, a managerial personnel of a company with no or insufficient earnings is also entitled to perquisites such as contribution to provident fund, gratuity, and encashment of leave at the conclusion of the tenure. Private Companies are exempt from the restrictions on managerial remuneration proposed under Sections 197 (including Schedule V).

WHAT DOES EFFECTIVE CAPITAL MEAN? For the purposes of Schedule V, the term "effective capital" is defined as follows:

1) Paid-up share capital (excluding of share application funds and advances against shares);

2) Share Premium

3) Surplus and Reserves

4) Long-term loans and deposits with a one-year repayment period (excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short-term arrangements)

A sub total (1 + 2 + 3 + 4)

5) Investing (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities),

6) Losses accumulated

7) Preliminary expenses are not deducted.

Subtotal B (5 + 6 + 7)

A - B = Effective Capital

When a manager is appointed during the fiscal year in which the company is formed, the effective capital is determined as of the date of such appointment. In all other cases, the effective capital is computed as of the last day of the fiscal year preceding the fiscal year in which the managing person is appointed.

Summary

- Underwriting guarantees the proposed issue of shares since it provides insurance against the risk.
- It also enables a company to get the required minimum subscription.
- Even if the public fails to subscribe, the underwriters will fulfill their commitments.
- The term 'remuneration' refers to any money or its equivalent given to any person in exchange for services rendered, and it includes the perquisites mentioned in the Income-tax Act of 1961.
- Managerial remuneration is the remuneration paid to managerial personnel. In this context, managerial personnel include directors, including managing directors and full-time directors, as well as managers.

Keywords

- Underwriting of shares and debentures
- Underwriting commission
- Disclosure requirement
- Managerial remuneration

Self Assessment

1. A person who undertakes to take up the entire or a portion of the offered shares or debentures that are not subscribed for by the general public is known as -........

A. Author
B. Shareholder
C. Broker
D. Underwriter

2. Tell the nature of underwriting contract?

A. Indemnity
B. Bailment
C. Guarantee
D. Pledge

3. According to SEBI guidelines, what is the minimum subscription of the issued amount?

A. 50 percent

B. 70 percent

C. 80 percent

D. 90 percent

4. According to SEBI regulations, the minimum application fee must not be less than -............

A. 25% of the issuance price

B. 5% of the nominal value

C. 5% of the issue price

D. 25% of the nominal value

5. Which of the following is a required requirement for underwriting commission payment?

A. The payment of commission must be permitted by the articles of incorporation of the company.

B. No commission must be paid to any underwriter for securities that are not offered to the public for subscription.

C. A copy of the contract for commission payment is delivered to the Registrar at the time the prospectus for registration is delivered.

D. All of the preceding

6. The underwriting commission may be paid from ____________?

A. the proceeds of the issue

B. the company's profit

C. the securities premium

D. All of the above.

7. In the case of a share issue, the underwriting commission shall not be more than _________?

A. 5% of the issue price

B. 5% of the nominal value

C. 10% of the market price

D. 10% of the nominal value

8. A firm commitment by an underwriter to purchase a specific number of shares or debentures of a company, regardless of the amount of shares or debentures paid for by the public, is known as -.................

A. Definite underwriting

B. Pakka underwriting

C. Marked underwriting

D. Firm underwriting

9. Unmarked applications must be delivered to underwriters in the following ratios?

A. Gross Liability Ratio

B. Last Agreed Ratio

C. Net Liability Ratio
D. Equal ratio

10. What are the applications bearing the respective underwriter's stamp?
A. Firm applications
B. Stamp applications
C. Underwritting application
D. Marked applications

11. Who is an underwriter?
A. Guarantees that if the public does not purchase all of the shares, the underwriters will.
B. Agrees to accept an underwriting commission at the prescribed proportion permitted by law.
C. both (A) and (B)
D. only (A) not (B)

12. Which of the following is a typical underwriter?
A. Financial institutions
B. Banks
C. Merchant bankers
D. All of the above

13. To act as an underwriter in India, which of the following institutions must issue a certificate of registration?
A. RBI
B. Central govt.
C. MCA
D. SEBI

14. ______ the account is credited on payment of the underwriter'scommission?
A. Underwriters A/c
B. Bank Account
C. Commission Account
D. A/C Profit & Loss

15. _________ account is debited, if underwriting commission is due?
A. Underwriters A/C
B. Profit and Loss A/C
C. Underwriting Commission A/C
D. None

Answer for Self Assessment

1.	D	2.	C	3.	D	4.	A.	5.	D.
6.	D	7.	A	8.	D	9.	A	10.	D
11.	C	12.	D.	13.	D	14.	B	15.	C

Review Questions

1. Explain the various types of underwriting of shares?
2. What is the accounting treatment for under writing in the books of company and underwriters?
3. Explain the provisions of the Companies Act, 1956 regarding disclosure of underwriting agreement?
4. What is managerial remuneration? Explain the various guidelines relating the remeneration given to managers under the Company Act?
5. Moon Ltd. filed a prospectus on January 1, 2005, requesting subscriptions for 10,00,000 equity shares of 10 apiece. The entire issuance was completely underwritten by A, B, C, and D as follows: A —— 30%; B —— 25%; C —— 35%; and D —— 10%. The following indicated applications were received for 8,00,000 shares: A —— 1,80,000; B —— 2,00,000; C —— 2,03,000; and D —— 1,67,000. Determine individual underwriters' liability.
6. Newton Ltd., which was founded on January 1, 2008, issued a prospectus requesting applications for 20,000 equity shares worth $10 each. A, B, and C fully underwrote the entire offering, as follows: A —— 10,000 shares; B —— 6,000 shares; and C —— 4,000 shares. Applications for 16,000 shares were received, with the following indicated applications: A —— 8,000 shares, B —— 2,850 shares, and C —— 4,150 shares. You must investigate the liability of individual underwriters.

Further Readings

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Unit 06: Final Accounts of Companies

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Meaning and accounting treatment in case of final account of companies.
- The nature of financial statements.
- Various uses and importance of financial statements.
- Objective and types of financial statements

Introduction

After we understand how a company raises capital, we must learn about the nature, objectives, and types of financial statements that it must prepare, as well as their contents, structure, uses, and restrictions. The financial statements are the outcome of the accounting procedure. They are created in accordance with accounting policies, accounting standards set by the Companies Act, accounting concepts, principles, and procedures, as well as the legal environment in which the business organizations operate. These statements are the result of the accounting summarization process and are thus the sources of information from which inferences about a company's profitability and financial status are derived. As a result, they must be arranged in a correct format with appropriate contents so that shareholders and other users of financial statements may easily understand and apply them in meaningful economic decisions.

6.1 Financial Statements and their Interpretation

Financial statements are the basic and formal annual reports that corporate management uses to communicate financial information to its owners and numerous other external parties such as investors, tax authorities, government, employees, and so on. These are the balance sheet (position statement) at the end of the accounting period, the company's profit and loss statement, and the cash flow statement.

6.2 Nature of Financial Statements

The chronologically documented facts about occurrences stated in monetary terms for a set period of time serve as the foundation for the creation of periodical financial statements that reflect the financial status as of a date as well as the financial results obtained during a period. According to the American Institute of Certified Public Accountants, financial statements are "statements prepared for the purpose of presenting a periodical review of progress by management and deal with the status of investment in the business and the results achieved during the period under review." They are based on a combination of documented facts, accounting standards, and subjective judgments."

The following points explain the nature of financial statements:

- Recorded Facts: Financial statements are prepared on the basis of facts recorded in accounting books in the form of cost data. The main basis for recording of transactions is the original cost or historical cost. The statistics for various accounts, such as cash in hand, cash at bank, trade receivables, fixed assets, and so on, are taken from the accounting records. The assets purchased at various times and prices are combined and shown at costs. The financial statements do not reflect the company's current financial situation because they are not based on market values.
- Accounting Conventions: While preparing financial statements, certain accounting conventions are observed. The convention of valuing inventory at cost or market price, whichever is lower, is followed. For balance-sheet purposes, assets are valued at cost less depreciation. When it comes to little value items like pencils, pens, postage stamps, and so on, the materiality convention is observed. Even though they are assets in nature, these items are classified as expenditure in the year they are purchased. The stationery is evaluated at cost, not on the basis of cost or market price, whichever is lower. Accounting principles make financial statements comparable, straightforward, and realistic.
- Postulates: Financial statements are based on several basic assumptions (prerequisites) known as postulates, such as the going concern postulate, money measurement postulate, realization postulate, and so on. The going concern assumption suggests that the enterprise is viewed as a going concern and has existed for a longer period of time. As a result, the assets are reported on a historical cost basis. The money measurement hypothesis states that the value of money remains constant across time. Despite changes in the purchasing power of money, assets purchased at separate eras will be listed at the price paid for them. Even if the sale price is not paid, the revenue is included in the sales of the year in which the transaction was made for producing the profit and loss statement.
- Personal Judgments: In certain cases, the facts and figures shown in financial accounts are dependent on personal judgment, estimates, and judgments. Depreciation is charged while taking into account the useful economic life of fixed assets. Estimates and personal judgments are used to make provisions for dubious debts. When valuing inventory, the lower of cost or market value is used. Many personal judgments must be made when determining the cost of inventory or the market value of inventory depending on specific parameters. Personal judgments, estimates, and opinions are used in the preparation of financial accounts to eliminate any chance of overstatement of assets and liabilities, income and spending, while adhering to the conservative norm.

- So, financial statements are summarized reports of recorded facts that are prepared in accordance with the accounting ideas, conventions, accounting policies, accounting standards, and legal obligations.

6.3 Objectives of Financial Statements

Financial statements are the primary sources of information for shareholders and other external parties seeking to understand a company's profitability and financial situation. They give information on the performance of the business concern in terms of assets and liabilities over a specified time period, which serves as the foundation for making decisions. Thus, the major goal of financial statements is to aid users in making decisions. The main objectives are the following:

- To provide information about a business's economic resources and obligations: They are prepared to provide adequate, reliable, and timely information about a business's economic resources and obligations to investors and other external parties who have limited authority, ability, or resources to obtain information.
- To offer information about the earning capacity of the business: They are to provide important financial information that can be used to predict, compare, and assess the earning capacity of the business firm.
- To give cash flow's information: They are to provide information beneficial to investors and creditors for anticipating, comparing, and assessing anticipated cash flows in terms of amount, timing, and associated uncertainties.
- To assess management effectiveness: They provide information that can be used to assess management's capacity to successfully employ a company's resources.
- Information regarding business activities impacting society: They must report on business activities affecting society as determined, characterized, or measured and that are significant in their social setting.
- Disclosure of accounting policies: These reports must give the major policies, ideas used in the accounting process, and modifications made during the year to better understand these statements.

Financial Statement Types- Financial statements typically include two statements: a balance sheet and a profit and loss statement, which are necessary for external reporting as well as internal management needs such as planning, decision-making, and control. Aside from these, there is a need to be aware of fund transfers and changes in the company's financial status. A cash flow statement is recommended for this purpose.

To harmonize the disclosure requirement with accounting standards and to converge with new reforms, every company registered under the Companies Act 2013, every company shall prepare its balance sheet, statement of profit and loss, and notes to account in accordance with the manner prescribed in the revised Schedule III to the Companies Act, 2013.

6.4 Balance sheet statement

Balance Sheet as at 31st March, 20..

Particulars	Note No.	Figure as at the end current reporting period	Figure as at the end previous reporting period
I. EQUITY AND LIABILITIES			
(1) Shareholders' funds			

(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-current liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long-term provisions			
(4) Current liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
Non-current assets			
(1) (a) Fixed assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under			
Development			

(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long-term loans and advances			
(e) Other non-current assets			
(2) Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
TOTAL			

6.5 Main Features of Presentation

- It applies to all Indian corporations that prepare financial statements in accordance with Schedule III of the Companies Act, 2013.
- It does not apply to a) Insurance or banking sector, or (ii) companies for which a balance sheet or income statement format is prescribed by another Act.
- Accounting standards supersede Schedule III of the Companies Act of 2013.
- The disclosure as depicted in front of the financial statements or in the notes is required.
- Terms in the amended Schedule III will be defined in accordance with the applicable accounting rules.
- A balance must be struck between providing excessive details that may not be useful to users of financial statements and not providing vital information.
- Current and non-current asset and liability bifurcation is relevant.
- It is necessary to round off requirements (refer box 1).
- A vertical format for presenting financial statements is required (refer Exhibit 3.1).
- The debit balance in the profit and loss statement must be stated as a negative amount under the heading "Surplus."
- Required disclosure of share application funds pending allotment.
- "Sundry Debtors" and "Sundry Creditors" have been substituted by the phrases "Trade Receivables" and "Trade Payables." Shareholders Fund- The shareholders' funds are subdivided on the balance sheet.

  a) Capital stock

  b) Reserves and surplus

  c) Money received in exchange for Share Warrants.

Share Capital

Notes to accounts must include disclosures about share capital. The following changes/additions are significant:

a) At the beginning and end of the reporting period, the number of shares outstanding for each class of shares must be recognized.

b) The rights, preferences, and restrictions associated to each class of shares, including dividend distribution and capital repayment restrictions.

c) In order to establish the identity of the company's ultimate owners:

i) Disclosure of shares held by the business's holding company or its ultimate holding company in respect of each class, including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate.

ii) Disclosure of shares in the company held by each shareholder with more than 5% of the voting power, including the number of shares held.

iii) Disclosure of the following for the five years immediately preceding the balance sheet date:

- The total number and class of shares allotted as fully paid up pursuant to contracts without cash payment.
- The total number and class of shares allotted as fully paid up through bonus shares.
- The total number and type of shares repurchased. It should be noted that the information given on the face of financial statements about shareholders' funds is confined to broad and significant elements. Notes to Accounts provide more information.

d) For each class of share capital:

i) The number and value of authorized shares.

ii) The number of shares issued, subscribed, fully paid and subscribed but not fully paid.

iii) Per share par value

iv)A reconciliation of the number of shares outstanding at the start and conclusion of the fiscal period.

v)Rights, preferences, and restrictions attached to each class of shares, including restrictions on dividend distribution and capital repayment.

vi) Aggregatenumber of shares in the company held by its holding company and ultimate holding company, including shares held by subsidiaries or associates of the holding company or the ultimate holding company.

vii) Shares reserved for issuance under options and contracts/commitments for the sale/disinvestment of shares, including terms and amounts.

viii) For the five years preceding the date on which the balance statement is prepared:

(a) Shares reserved pursuant to contracts/commitments.

(b) The number and type of shares repurchased.

(c) The number and type of shares authorized for consideration, excluding cash and bonus shares.

ix) For the five years preceding the date on which the balance statement is prepared:

(a) Shares reserved pursuant to contracts/commitments.

(b) The number and type of shares repurchased.

(c) The number and type of shares authorized for consideration, excluding cash and bonus shares.

x) Provisions of any securities to be converted into equity/preference shares issued in descending order, beginning with the most distant such date.

xi) Unpaid calls (aggregate).

xii) Shares forfeited (amount originally paid up).

Reserve and Surplus

Reserves and surplus must be divided into the following categories:

i) Capital Reserve

ii)Capital Redemption Reserve

iii)Securities Premium Reserve

iv)Debenture Redemption Reserve

v)Revaluation Reserve

vi)Share Options Outstanding Account vii)Other Reserves (Specifying nature and purpose)

viii)Surplus: A balance in the profit and loss statement that discloses allocations and appropriations such as dividends, bonus shares, transfers to/from reserves, and so on. The following are significant additions/modifications to the disclosure of reserve and surplus:

a)A "Fund" is a reserve that is particularly represented by allocated investments.

b)The 'Debit' balance of the profit and loss statement must be shown as a negative amount under the 'Surplus' heading.

c)The balance of "Reserve and Surplus" after adjusting for any negative Surplus balance, if any, shall be given under "Reserve and Surplus" read even if the final amount is "negative."

d)The outstanding account for share options has been recognized as a distinct item under 'Reserve and Surplus.' According to the ICAI's Guidance Note on Accounting for Employee Share-Based Payments, a credit balance in the 'Stock option outstanding Account' must be declared in the balance sheet under a distinct heading' between share capital and reserves and surplus as part of the shareholders fund.

Money received in exchange for share warrants- This is the sum received by the company that is converted into shares at a particular date and rate. The instrument was issued as share warrants in exchange for the money received. Money received in exchange for share warrants will be reported as a separate line item under 'shareholder's fund.'

Deferred tax assets and liabilities are non-current. This is in conformity with the Companies Act's Schedule III.

Trade payables Sundry creditors have been renamed Trade payables and are divided into two categories: current and non-current. Trade payables that are not settled within 12 months of the balance sheet date or within the operating cycle are categorized as "other long-term liabilities" with a Note to Account. Purchase of goods and services in the normal course of business, for example. On the balance sheet, the balance of trade payables is categorized as current liabilities.

Proposed Dividend The Board of Directors proposes a dividend, which the shareholders proclaim (agree) during their Annual General Meeting. After the annual accounts for the year have been compiled, the Board of Directors proposes the dividend. The Annual General Meeting of Shareholders is conducted in the following fiscal year. Shareholders can cut the proposed dividend amount but not enhance it. Because the declaration of the proposed (final) dividend is subject to shareholder approval, the proposed payout is shown as a contingent liability. AS-4, Events, and Contingencies The proposed dividend will be shown in the Notes to Accounts if it occurs after the Balance Sheet Date. Following the declaration of the proposed dividend by the shareholders, it becomes a liability for the firm and is recorded in the books. As a result, the previous year's proposed dividend will be declared (approved) by shareholders in the current year, and this declared (approved) proposed dividend will be accounted for during the year. The proposed dividend for the current fiscal year will be applicable for the following fiscal year. In summary, a proposed dividend from the previous year will be accounted for in the current year if it is declared (approved) by shareholders at their annual general meeting.

ProvisionsThe amount of provision paid within 12 months of the balance sheet date or within the operating cycle time from the date of its recognition is categorized as short term provisions and is reflected on the face of the balance sheet under current liabilities. Others are shown on the balance sheet as long-term provisions under non-current liabilities.

Fixed assets The treatment of fixed assets remains unchanged. Non-current assets include both tangible and intangible assets. It should also be noted that if the asset's useful life is less than 12 months, it will still be classified as non-current.

Investmentsare also divided into two types: current and non-current. Current investments are those that are expected to be realized within the next twelve months and are classified as current assets. Non-current investments are categorized as non-current assets. Both are, nevertheless, shown on the balance sheet.

InventoriesAll inventories are always considered to be current.

Trade receivables Trade receivables realized after twelve months from the reporting date/from the date of their recognition are classed as "Other non-current assets" under the heading non-current assets with Note to Accounts. For example, an usual course of business sale of goods or services. Others are categorized as current assets and displayed on the balance sheet.

Cash and cash equivalent It is constantly up to date, however only sums that qualify as cash and cash equivalents under AS-3 are listed here. It has precedence over Schedule III, and cash and cash equivalents must be disclosed in line with the stipulated standard.

Practical Question- Ajay Ltd. issued 5,000 10% debentures of Rs. 100 each at par, redeemable at a 5% premium after 5 years. Include these elements in the company's balance sheet.

Particulars		Note No.	Amount (Rs.)
I. Equity and Liabilities			
1. Shareholders' Funds			
Reserve and Surplus			(25,000)
a) Long term borrowings		2	5,00,000
b) Other long-term liabilities		3	25,000
Total			**5,00,000**
II. Asset			
1. Current Assets			
a) Cash and Cash Equivalents			5,00,000
Total			**5,00,000**

Notes to accounts

Particulars	Amount
1. Reserves and Surplus i.e. Balance in Statement of Profit & Loss	(25,000)
2. Long Terms Borrowings	
500 10% debenture Rs. 100 each	5,00,000
3.Other long term liabilities	
Premium on Redemption of Debentures	25,000
4. Cash and Cash Equivalents Cash at bank.	5,00,000

6.6 Form and Content of Statement of Profit and Loss

Statement of Profit and Loss for the year ended

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
I	Revenue from operations			

II	Other income			
III	Total Revenue (I + II)			
IV	Expenses:			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods work-in-progress and Stock-in-Trade			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expense			
	Other expenses			
	Total expenses			
V	Profit before exceptional and extraordinary items and tax (III - IV)			
VI	Exceptional items			
VII	Profit before extraordinary items and tax (V - VI)			

VIII	Extraordinary items			
IX	Profit before tax (VII- VIII)			
X	Tax expense:			
	(1) Current tax			
	(2) Deferred tax			
XI	Profit (Loss) for the period from continuing operations (VII-VIII)			
XII	Profit/(loss) from discontinuing operations			
XIII	Tax expense of discontinuing operations			
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)			
XV	Profit (Loss) for the period (XI + XIV)			
XVI	Earnings per equity share:			
	(1) Basic			

	(2) Diluted			

6.7 Items of Profit and Loss Statement

The following profit and loss statement items are discussed:

1.Revenue from operations- It includes

(i)Product sales,

(ii)Service sales, and

(iii)Other operating revenues.

In the case of a finance corporation, revenue from operations includes interest, dividends, and income from other financial services. It should be noted that, to the extent relevant, each of the following headings must be declared separately via notes to accounts.

2. Other sources of income

(i)Interest income (if not a financial firm),

(ii)Dividend income,

(iii)Net gain/loss on sale of investments,

(iv) Other non-operating income (net of expenses directly attributable to such income).

Expenses-Costs incurred to earn the money given under the several headings listed below:

(a)Cost of Materials.	It is applicable to manufacturing firms. It is made up of raw materials and other materials used in the production of items.
(b)Purchase of Stock-in-trade-	It refers to the acquisition of items for the aim of trading.
(c)Changes in inventories of finished goods, WIP and stock-in-trade	It is the distinction between opening inventory (stock) finished goods, work in progress (WIP), and closing stock-in-trade inventory.
(d)Employees benefit expenses	This category includes employee expenses such as salaries, wages, leave encashment, staff welfare, and so on. Employee benefit expenses are further classified as direct and indirect.
(e)Finance cost	It is the expense for interest charges on borrowings during the year. Under this heading, just the interest expense is to be shown. Other financial expenses, such as bank fees, are displayed under "Other Expenses."
(f)Depreciation	Depreciation is the reduction in the value of fixed assets, whereas amortization is the reduction in the value of intangible assets.
(g)Other expenses	All other expenses that do not fit into one of the above categories are included under other expenses. Other expenses can be divided into three categories: direct expenses, indirect expenses, and non-operating expenses.

6.8 Uses and Importance of Financial Statements

Management, investors, shareholders, creditors, the government, bankers, employees, and the general public are all users of financial statements. Financial statements provide critical information about the management's performance to those interested in the organization and aid in making suitable economic decisions. It should be emphasized that, in addition to the directors' report, auditors' report, corporate governance report, and management discussion and analysis, the financial statements are a vital part of the company's annual report.

The following are the numerous applications and significance of financial statements:

- Report on stewardship function: Financial statements provide information to shareholders about the performance of management. Financial statements can be used to understand the gaps between management performance and ownership expectations.
- Basis for fiscal policies: Fiscal policies, particularly government taxation policies, are linked to the financial performance of company operations. The financial accounts serve as the foundation for the government's industrial, taxes, and other economic policies.
- Granting of credit: Corporations must borrow money from banks and other financial organizations for a variety of reasons. Credit issuing organizations base their choices on the financial performance of the enterprises. Thus, financial statements serve as the foundation for credit approval.
- Primary considerations for prospective investors: Prospective investors include both short-term and long-term investors. Their primary investment considerations are security and liquidity of their money, as well as adequate profitability. Financial statements assist investors in determining the company's long-term and short-term solvency, as well as its profitability.
- Guide to the value of previous investments: Shareholders of companies want to know the status, safety, and return on their investment. They may also require information in order to decide whether to continue or discontinue their investment in the business. Financial statements inform shareholders while making such crucial decisions.
- Helps trade associations in assisting their members: Trade associations may analyze financial statements in order to provide service and protection to its members. They might create standard ratios and a standardized accounting system.
- Aids stock exchanges: Financial statements assist stock exchanges in understanding the level of openness in reporting financial performance and enable them to request necessary information to defend investors' interests. The financial accounts allow stock brokers to assess the financial position of various companies and make recommendations on the prices to be quoted.

6.9 Limitations of Financial Statements

Despite the fact that financial statements are prepared with great care and provide precise information to users, they have the following limitations:

Financial statements are prepared on the basis of historical cost, not present condition. Because money's purchasing power fluctuates, the values of assets and liabilities shown in financial statements do not reflect the current market condition.

Assets may not realize: Accounting is performed in accordance with specific conventions. If the corporation is forced to liquidate, certain of its assets may not realize their declared valuations. Balance-sheet assets only reflect unexpired or unamortized cost.

Bias: Financial statements are the result of recorded facts, accounting principles and conventions employed and personal judgments made by accountants in various scenarios. As a result, bias in the findings may be seen, and the financial position depicted in financial statements may not be realistic.

Aggregate data: Financial statements display aggregate data but not specific data. As a result, they may not be of much assistance to users in making decisions.

Missing critical information: The balance sheet does not disclose information on market losses and agreement terminations, both of which have a significant impact on the firm.

No qualitative information: Financial statements only include monetary information and do not include qualitative information such as industrial relations, industrial atmosphere, labour relations, work quality, and so on.

They are simply preliminary reports: The Profit and Loss Statement shows the profit/loss for a specific time period. It does not provide a notion of the earning potential over time, and similarly, the financial situation indicated in the balance sheet is true at that point in time, with no indication of the expected change on a future date.

Summary

Financial Statements: These are the final products of the accounting process that reflect the financial results of a set period and the financial situation as of a specific date. Corporate undertakings create and publish financial statements for the benefit of diverse stakeholders. These statements contain the profit and loss statement and the balance sheet. The primary goal of these statements is to provide information needed for decision-making by management as well as those outsiders who are interested in the undertaking's activities.

The balance sheet: On a given date, the balance sheet shows all of the company's assets, all of its commitments or liabilities to outsiders or creditors, and all of the owners' claims. It is one of the key sentences illustrating the Statement of Profit and Loss: The Statement of profit and loss is prepared for a specific period to determine the operational results of an undertaking. It is a statement of revenue earned and the expenses incurred for earning the revenue. It is a performance report showing the changes in income, expenses, profits and losses as a result of business operations during the year between two balance sheet dates.

Significance of Financial Statements: The users of financial statements include Shareholders, Investors, Creditors, Lenders, Customers, Management, Government, etc. Financial statements help all the users in their decision-making process. They provide data about general purpose needs of these members.

Limitations of Financial Statements: Financial statements are not free from limitations. They provide only aggregate information to satisfy the general purpose needs of the users. They are technical statements understood by only persons having some accounting knowledge. They reflect historical information but not current situation, which is essential in any decision making. In addition, one can get idea about the organization’s performance in terms of quantitative changes but not in qualitative terms like labor relations, quality of work, employees satisfaction, etc. The financial statements are neither complete nor accurate as the flow of income and expenses are segregated using best judgment apart from accepted concepts. Hence, these statements need proper analysis before their use in decisionmaking.

Financial statements are used by a variety of people, including shareholders, investors, creditors, lenders, customers, management, and the government. All users benefit from financial statements in their decision-making process. They provide information about these members' general purpose needs. Financial Statement Limits: Financial statements are not without limitations. They merely give aggregate information to meet the users' general purpose demands. They are technical statements that only someone with some accounting knowledge can understand. They reflect past data but not the current condition, which is critical in making decisions. Furthermore, one can gain a sense of the organization's performance in terms of quantitative changes but not in qualitative ones such as labor relations, work quality, employee satisfaction, and so on. The financial accounts are not complete nor accurate.

Keywords

- Final accounts of companies
- Statement of Profit & Loss
- Depreciation and amortization
- Exceptional items

Self Assessment

1. Name the items do not come under, reserves & surplus?
A. Capital redemption reserve
B. Retained earnings
C. Provident fund
D. Revenue reserve

2. What will be the Net income / net loss if Opening balance of Profit & Loss A/c was Rs 7,500, dividend paid Rs 1,500, and closing balance of Profit & Loss A/c was Rs. 5000.
A. Loss Rs 1,000
B. Net loss Rs 3,000
C. Net Income Rs 1,000
D. Profit Rs 6,500

3. Companies' final accounts must be produced in conformity with the provisions of _________ of the Companies Act.
A. Schedule V
B. Schedule III
C. Schedule IX
D. Schedule X

4. The final accounts for the company are prepared in ____________ format.
A. Vertical
B. Horizontal
C. Both A and B
D. None

5. The précised Balance Sheet in _______ format is complemented by schedules that provide further information.
A. Vertical
B. Horizontal
C. Both A and B
D. Convenient

6. Where the balance in Share Forfeiture Account after reissue of forfeited shares is shown**?**
A. Revenue reserve
B. Share premium
C. Capital reserve
D. Retained earning

7. The exchange difference for the repayment of a liability related to the purchase of fixed assets must be reported as a change on _______?
A. Fixed asset

B. Share premium
C. capital reserve
D. Retained earning

8. When is business assumed to be in a profit?
A. Spending outweighs income.
B. Income surpasses spending
C. The income surpasses the liability.
D. Assets outnumber expenditures.

9. When expenses rise, what does the accounting double-entry system say?
A. There is no need to keep an accounting record.
B. Credited.
C. Debited.
D. Both (B) and (C)

10. Which option provides a review on the firm's financial situation as of a certain date?
A. Income and Expense Account
B. Balance Sheet
C. Statement of Cash Flows
D. Reserve and Surplus A/c

11. Which of the following does not qualify as an intangible asset?
A. Building
B. Copyright
C. Goodwill
D. Patent

12. Which of the following does qualify as current liability?
A. Creditors
B. Bank
C. Receivables
D. Land

13. What to do with the unfavorable profit and loss account balance?
A. Liabilities are subtracted.
B. Deducted from capital
C. Removed from current assets
D. Included liabilities

14. Which of the following does not belong to category of Tangible fixed assets?
A. Land and structures
B. Machinery and plant

C. Livestock
D. Formulas and designs

15. Which of the following is not reported as a Current Liability in a company's Balance Sheet prepared in accordance with Schedule III of the Companies Act, 2013?
A. Accounts payable;
B. short-term borrowings;
C. deferred tax liabilities
D. Temporary Provisions

Answers for Self Assessment

1.	C	2.	A	3.	B	4.	A	5.	A
6.	C	7.	A	8.	B	9.	C	10.	B
11.	A	12.	A	13.	B	14.	D	15.	C

Review Questions

1. Describe the purpose of the financial statements.
2. Explain the relevance of the financial statements in detail.
3. Describe the disadvantages of the financial statements.
4. Prepare the format for a profit and loss statement and explain its items up to the ascertainment of profit before tax.
5. Explain the balance sheet format and elucidate the various balance sheet elements.
6. How are financial statements beneficial to the many stakeholders engaged in an enterprise's affairs?
7. From the following particulars, prepare Statement of profit and loss for the year ending March 2020, as per the revised Schedule VI:

	Rs.
plant and Machinery	1,60,000
Land	6,74,000
Depreciation of Plant	16,000
Purchases adjusted	4,00,000
Closing stock	50,000
Wages	1,20,000
Sales Net	10,00,000
Salaries	80,000
Bank overdraft	2,00,000
10% Debenture issued on 1.4.2012	1,00,000
Equity share capital Rs. 100 each	2,00,000
1000, 6% Pref. Shares Rs. 100 each	1,00,000

Additional information

(i) Equity dividend @ 10% declared on paid up capital.

(ii) Dividend on the preference share capital paid in full.

(iii) Rs. 2, 00,000 transferred to general reserve.

8. From the given particulars of Sun Shine Co. Ltd. as at March 31, 2020, prepare balance sheet in accordance to the (revised) Schedule VI:

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
Preliminary expenses	2,40,000	Goodwill	30,000
Discount on Issue of shares	20,000	Loose Tools	12,000
10% Debentures	2,00,000	Motor vehicles	4,75,000
Stock in trade	1,40,000	Provision for tax	16,000
Cash at bank	1,35,000		
Bills receivables	1,20,000		

Further Readings

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Unit 07: Valuation of Shares

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Meaning of valuation of shares
- Methods of valuation of shares;
- Factors affecting valuation of shares;
- Accounting treatment for valuation of shares

Introduction

The process of determining the worth of a company's shares is known as share valuation. Share valuation is done using quantitative methodologies, and share value varies according to market demand and supply. The share price of publicly traded listed corporations is easily accessible. However, in the case of private corporations whose shares are not publicly traded, share value is extremely significant and difficult.

7.1 When is a Share Valuation Required

Some of the situations in which share valuation is significant are as follows:

- One key reason is when you are going to sell your firm and want to know how much it is worth.
- When you approach your bank for a loan based on shares as a security
- Merger, acquisition, reconstruction, amalgamation, etc - valuation of shares is very important
- When your company shares are to be converted i.e. from preference to equity
- Valuation is required when implementing an employee stock ownership plan (ESOP)
- For tax assessments under the wealth tax or gift tax acts
- In case of litigation, where share valuation is legally required
- Shares held by an Investment company

- Compensating the shareholders, the company is nationalized. Sometimes, even publicly traded shares have to be valued because the market quotation may not show the true picture or large blocks of shares are under transfer etc.

7.2 Factors Influencing Share Valuation:

1. Demand and supply- The price of securities is influenced by supply and demand. When the demand for securities exceeds the supply (buyers outnumber sellers), the price of securities rises. On the other hand, if the demand for securities is smaller than the supply (buyers outnumber sellers), the price of securities falls.

2. The bank rate- Lower bank rates (lower interest rates) would increase demand for cash and decrease demand for securities. In the case of a higher bank rate (high interest rate), the demand for funds and thus the demand for securities would be lower.

3. Market participants- Market participants have an impact on security pricing. Securities prices will rise if the number of bulls outnumbers the number of bears. On the other hand, if the bears outnumber the bulls, the price of securities will fall.

4. Announcements of dividends- Dividends serve as a signaling device for the movement of stock prices. Dividend announcements have an impact on stock prices. When firms declare dividends, the share values of those companies tend to rise. The key aspect to remember is that if the dividend rate disclosed is lower than what investors expected, share prices will fall, and if it is higher than expectations, share prices will rise.

5. Management background- Management profiles have a big impact on company success, and thus have a significant impact on share prices. Share prices would grow if the management team consisted of educated, experienced individuals with a successful track record. If the company is taken over by management with a bad reputation, the share price will reduce.

6. Trade cycle- The term "trade cycle" refers to the cyclical oscillations in economic activity. During a boom, share prices would be at their highest, while during a depression, they would be at their lowest. During a recovery, share prices would gradually rise, but during a recession, they would decrease.

7.Speculation- If there is a lot of speculation in the market or a lot of speculation in a stock, the price of that share will fluctuate a lot. If speculation is at a low level, share price movements will be reduced.

8. Political considerations- Share prices are influenced by political variables such as the ideology of the ruling party, government programmes, and relations with other countries. For example, when the UPA administration won elections, share prices plummeted because it was assumed that the government's policies would be influenced by communist groups.

9. Workplace relations- If there is a good relationship between the workers and the company's management, productivity will be high, resulting in higher profits. As a result, share prices would rise. When workplace relations are weak and strikes and lockouts occur on a regular basis, the company's performance suffers. As a result, stock prices would plummet.

10. Government stability- When the government is stable, businessmen are more likely to engage in new ventures and grow existing ones. As a result of increased production, sales, and profits, share prices would rise. New investments are not made when the government is unstable. Demand, production, and earnings are down, and stock values are down.

11. Market sentiment in general-It is widely assumed that sentiments influence market behavior. If market participants are optimistic, more buying will occur, leading to an increase in share prices. If market participants are pessimistic, more selling will occur, causing share prices to fall.

12. Institutional investors' actions- Institutional investors, such as mutual funds, investment trusts, and pension funds, have an impact on share prices. They have a large sum of money at their disposal. When they start buying, share prices rise; when they sell, share prices fall.

13. Foreign investment volume- Foreign institutional investors (FIIs) have recently played a significant role in influencing share prices. If the level of foreign investment in the market rises (more people buying shares), share prices rise as well. If the level of foreign investment falls or FIIs sell their investments, the markets will fall.

14. Returns provided by other markets- If Indian markets offer high returns, institutional investors (particularly FIIs) will invest in them. Share prices would rise as demand increased. If the returns offered by other countries' markets are appealing, institutional investors will sell their securities in order to invest in those markets. Shares would be sold in large quantities in such cases.

15. Credit availability- If credit is widely available with few restrictions, investors will borrow to invest in the markets. Demand for shares would increase, causing prices to rise. If credit is restricted, borrowing will be lower, and demand for stocks will be lower as well.

16. Effective regulation- If the stock market is run transparently and effectively, investors will feel confident in investing. As a result, more buying would occur, and share prices would rise. Investors will lose confidence if regulation is ineffective and scams occur (Harshad Mehta scam, MS Shoes scam, CRB scam, Ketan Parekh scam, and the recent IPO scam). They will feel panic and sell their stock, as a result, prices would fall. After we understand how a company raises capital, we must learn about the nature, objectives, and types of financial statements that it must prepare, as well as their contents, structure, uses, and restrictions. The financial statements are the outcome of the accounting procedure. They are created in accordance with accounting policies, accounting standards set by the Companies Act, accounting concepts, principles, and procedures, as well as the legal environment in which the business organizations operate. These statements are the result of the accounting summarization process and are thus the sources of information from which inferences about a company's profitability and financial status are derived. As a result, they must be arranged in a correct format with appropriate contents so that shareholders and other users of financial statements may easily understand and apply them in meaningful economic decisions.

7.3 What are Share Valuation Methods

There is no single valuation method that will fit all purposes; thus, different methods of share valuation exist depending on the purpose, data availability, nature and volume of the company, and so on.

1. **Asset-based financing (Net asset or intrinsic value or net worth or breakup value method)** - This method is based on the monetary value of the company's assets and liabilities, which include intangible assets and contingent liabilities. This approach could be very useful for manufacturers, distributors, and other businesses that use a large amount of capital assets. This approach is also used to confirm the conclusions reached through the income or market approaches.

   The value of each share is calculated by dividing the company's net asset value by the number of shares. The following are some important points to consider when valuing shares using this method:

   - The company's entire asset base, including current assets and liabilities such as receivables, payables, and provisions, should be considered.
   - Fixed assets must be valued at their realizable value.
   - It is critical to value goodwill as part of intangible assets.
   - Unrecorded assets and liabilities must also be considered.
   - False assets, such as preliminary expenses, discounts on shares and debentures, accumulated losses, and so on, should be eliminated.

   To calculate the net asset value, subtract all external liabilities from the total asset value of the company. To determine the value of a share, the net value of assets must be divided by the number of equity shares. The net asset is calculated by adding all assets at market value, including net investments, and deducting preference share capital if applicable. Land and buildings+ plant and machinery+ furniture+ stock+ debtors+ bill receivable+ cash+ goodwill-debentures-current liabilities-preference share capital-dividend arrears and divided by number of equity shares.

   The following is the formula:

   Net assets / number of equity shares = value per share

This method is advantageous because it considers goodwill and is useful when a company is going out of business, and is also accepted by tax authorities. However, it is not suitable for a growing company.

2. Earning capacity or yield valuation or income method: - The share is valued using this method by comparing the expected rate of return to the normal rate of return. If ERR exceeds NRR, the market value of the share exceeds the paid-up amount. Otherwise, the share's market value is less than its paid-up value. The steps for this method are as follows:

i) Determine the expected profit available to equity shareholders by factoring in taxation, transfers to reserves, transfers to debenture redemption funds, and preference dividends. This is the amount of money available to equity shareholders.

ii) The expected rate of return (ERR) is calculated as follows:

ERR = amount available to equity shareholders *100/ paid up equity share capital

iii) The final step is to compute the value of the share.

Share value = ERR* Paid up value per share/NRR

This method is appropriate for growing businesses and small investors, but it does not take the company's net asset into account.

In summary, the formulas are

Earnings rate expected- (profit after tax / equity share paid up value) x 100

(Expected rate of earnings or dividend / Normal rate of return) x Paid up equity value = value per share

3. Fair value or dual method: This method combines the two preceding methods.Share fair value = (Intrinsic value + yield value)/ 2

4. Market-based- The market-based approach typically employs comparable public company share prices and comparable private company asset or stock sales. Private company data can be obtained from a variety of proprietary databases available on the market. What is more important is how to select comparable companies - there are many factors to consider, such as the nature and volume of the business, industry, size, financial condition of the comparable companies, transaction date, and so on.

7.4 How to Select a Share Valuation Method

There are various reasons for using a specific method for valuing shares; it generally depends on the purpose of valuation. In general, combining methods yields a more reliable valuation. Let us look at each approach to see what the main reason is:

1. Assets Approach- If a company is capital-intensive and has invested significantly in capital assets, or if the company has a significant volume of capital work in progress, an asset-based approach can be used. This method can also be used to value shares during a company's amalgamation, absorption, or liquidation.
2. Income Approach- This approach has two methods: discounted cash flow (DCF) and price earning capacity (PEC). The DCF method determines fair value by projecting future cash flows, and it can be used if this data is reasonably available. The PEC method is based on historical earnings, and if an entity has not been in business for a long time and has only recently begun operations, this method cannot be used.
3. Market Approach- The market value of the shares is considered for valuation under this approach. However, this approach is only viable for publicly traded companies with open market share prices. If there is a set of peer companies that are listed and engaged in a similar business, the share public prices of such companies can also be used.

Practical Questions

Q7. a) The following is the Balance Sheet of NSC Ltd. as on 31st Dec 1998.

Liabilities	Rs.	Assets	Rs.
4,000 10% pref. shares of Rs. 100 each 60,000 equity shares of Rs. 10 each Bills Payable Creditors	4,00,000 6,00,000 50,000 1,50,000	Sundry assets at book value	12,00,000
	12,00,000		**12,00,000**

The market value of 60% of the assets is estimated to be 15% greater than the book value, while the remaining 40% is estimated to be 10% less than the book value. A liability of Rs. 10,000 is unrecorded. Determine the worth of each equity share (it is to be assumed that preference shares have no prior claim as to payment of dividend or to repayment of capital).

Solution- Net asset calculation:

	Rs.	Rs.
Sundry assets:		
12,00,000 x 60% x 115%		8,28,000
12,00,000 x 40% x 90%		4,32,000
		12,60,000
Less: Current Liabilities:		
Bills Payable	50,000	
Creditors	1,50,000	
Unrecorded Liability	10,000	2,10,000
		10,50,000
Less: Preference Share capital		4,00,000
Net assets available for equity shareholders		6,50,000

$$\text{Intrinsic value per share} = \frac{\text{Net assets for equity shareholders}}{\text{No. of equity shares}}$$

$$= \frac{6,50,000}{60,000}$$

$$= \text{Rs. } 10.83$$

Q7. b) SaraswatiCo. Ltd.'s balance sheet as of December 31, 1998, revealed the following position.

Liabilities	Rs.	Assets	Rs.
Share Capital		Goodwill	1,65,000
6,000 equity shares of Rs.100	6,00,000	Investments	5,25,000
each	75,000	Stock	6,60,000
Profit & Loss A/c	2,25,000	Sundry Debtors	3,90,000
General Reserve	4,50,000	Cash at Bank	60,000
6% Debentures	1,50,000		
Sundry Creditors	3,00,000		
Workmen's Savings bank A/c			
	18,00,000		**18,00,000**

i) Profits for the previous five years were as follows: Rs. 30,000 in 1994, Rs. 70,000 in 1995, Rs. 50,000 in 1996, Rs. 55,000 in 1997, and Rs. 95,000 in 1998.

ii) The investment's market value was Rs. 3,30,000.

iii) Goodwill is to be valued at three years' worth of average annual profits over the previous five years. Determine the intrinsic value of each stock.

Solution- Intrinsic share value calculation

Net Assets Calculation:

Assets at Market value Goodwill 1,80,000 Investments 3,30,000 Stock 6,60,000 Sundry Debtors 3,90,000 Cash at Bank 60,000	16,20,000
Less: Liabilities 6% debentures 4,50,000 Sundry Creditors 1,50,000 Workmen" s Savings bank A/c 3,00,000	9,00,000
Net assets	7,20,000

Intrinsic Value of each share = 720000 / 6000 = Rs.120

Q7. c) On December 31, 2009, MA KALI Ltd.'s Balance Sheet revealed the following position:

Liabilities	Rs.	Assets	Rs.
Issued Capital in Rs. 10 shares	4,00,000	Fixed Assets	5,00,000
Reserves	90,000	Current Assets	2,00,000
Profit and Loss Account	20,000	Goodwill	40,000
5% Debentures	1,00,000		
Current Liabilities	1,30,000		
	7,40,000		7,40,000

The Net Profit for the three years were:

	Rs.
2007	51,600
2008	52,000
2009	51,650

Of which 20% was placed in Reserve, a proportion considered reasonable in the industry in which the company operates and where a fair investment return of 10% can be assumed. Determine the value of the company's stock using the yield-basis method.

Solution-

	Rs.
Average Profit = $\frac{\text{Rs. } 51,600 + \text{Rs. } 52,000 + \text{Rs. } 51,650}{3}$	51,750
Less : Transfer to Reserve @ 20%	10,350
Maintainable Profit	41,400

Here, the rate of dividend is not given, the same can be found out with the help of the following :

$$\text{Rate of Dividend} = \frac{\text{Profit}}{\text{Equity Capital (Paid-up)}} \times 100$$

$$= \frac{\text{Rs. } 41,400}{\text{Rs. } 4,00,000} \times 100 = 10.35\ \%$$

$$\text{Value of each Equity Share} = \left(\frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}}\right) \times \text{(Paid-up value of each Equity Share)}$$

$$= \text{Rs. } \frac{10.35}{10} \times \text{Rs. } 10$$

$$= \text{Rs. } 10.35$$

Q7. (d) Calculate the value of each Equity Share from the following information:

Share Capital	Rs,
20,000 equity shares of Rs. 10 each, Rs. 8 per share paid-up	1,60,000
1.000, 10% Preference Shares of Rs. 100 each, fully paid-up	1,00,000
Expected profit (before Tax and Pref. Dividend)	1,00,000
Normal Rate of Return	10%
Rates of Tax @ 50%	
Transfer to Reserve @ 20%	

Solution-

Calculation of Rate of Dividend	Rs.
Profit (before Tax and Pref. Dividend)	1,00,000
Less: Income-Tax @ 50%	50,000
	50,000
Less: Transfer to Reserve @ 20%	10,000
	40,000
Less: Pref. Dividend @ 10%	10,000
Available for equity shareholders	30,000

$$\text{Rates of Dividend} = \frac{\text{Profits (available for equity shareholders)}}{\text{Equity Share Capital (Paid-up)}}$$

$$= \frac{\text{Rs. } 30{,}000}{\text{Rs. } 1{,}00{,}000} \times 100$$

$$= 30\%$$

$$\text{Value of each equity share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-up value of each equity share}$$

$$= \frac{30\%}{10\%} \times \text{Rs. } 8$$

$$= \text{Rs. } 24$$

Summary

- Stock valuation is a method of determining a stock's intrinsic value. The stock's intrinsic or theoretical value is not linked or attached to its current market price. As a result, stock valuation is much more important.

- Stock valuation is required in order to determine the intrinsic value of a stock and make an informed decision about the sale or purchase of a stock. It is also critical to understand the depth of the stock's current market price and to be prepared for a market reaction.

Keywords

- Valuation of shares
- Intrinsic value of shares
- Income based method of valuation
- Dual method of valuation
- Normal rate of return

Self Assessment

1. What is the primary goal of the share valuation?
A. To advance a loan against the security of shares
B. For employees to purchase shares that they can keep for the duration of their employment
C. To purchase a block of shares to gain control of the company
D. All of the above

2. Name the assumption on which the net asset value method for the valuation of shares is based?
A. The company is going to be liquidated
B. The company is a going concern
C. Both a and b are incorrect
D. Both a and b are correct

3. A partially paid equity share has a value equal to ____________?
A. The value of a fully paid-up share minus the calls unpaid per share
B. The value of a fully paid-up share divided by the face value of a share
C. The value of a fully paid-up share
D. None of the above

4. Tell the primary reason why a share's intrinsic value is less than its market value.
A. The market is undervaluing the stock
B. The market is overvaluing the stock
C. The stock has a low level of risk
D. The stock has a high dividend payout ratio.

5. For the valuation of a share, the market-based methods should not be considered if _______?
A. A company's assets are less than its liabilities
B. The company is too small
C. Estimating the realizable value of a going concern becomes difficult
D. Its market price fluctuates dramatically

6. Tell the circumstance when the market value method for the valuation of a share is considered _________?
A. When the shares are not listed
B. When a division within the company is valued
C. When a company's shares are frequently traded on a stock exchange with nationwide trading
D. None

7. A company's shares are valued at ________ on its balance sheet.
A. Paid-up value

B. Market price
C. Adjusted market value
D. None of the aforementioned

8. Which of the following is not required to determine the yield value per share?
A. Super profit
B. Paid-up value
C. Normal return rate
D. Expected return rate

9. Under the net asset approach, the value of a share is determined by ___________?
A. net assets available to equity owners
B. net assets available to debenture holders
C. the net assets of preference shareholders
D. none

10. __________ is another name for net asset value.
A. The value of the asset backing
B. The intrinsic worth
C. The value of liquidation
D. All the above

11. When shares are to be valued?
A. Mergers
B. Sale of shares
C. Gift tax
D. A, B and C

12. What are the Quoted shares?
A. listed on the stock market index
B. quoted hourly
C. quoted by the seller
D. quoted by the customer

13. Net asset value is also considered as _________?
A. asset support value
B. intrinsic worth
C. liquidation worth
D. (a), (b), and (c)

14. The yield value of a share is determined by ___________?
A. Future sustaining profit
B. Paid-up equity capital

C. Normal rate of return

D. None

15. What is NRR?

A. Normal rate of return

B. Non resident

C. Nominal rate of return

D. None

Answer for Self Assessment

1.	D	2.	A	3.	A	4.	A	5.	D
6.	C	7.	A	8.	A	9.	A	10.	D
11.	D	12.	A	13.	D	14.	D	15.	A

Review Questions

1. Explain the concept of valuation of shares.
2. Describe the numerous methods of valuation of shares of company
3. What are the factors affecting the valuation of shares?
4. Why there is need for valuation of shares?
5. The following is the balance sheet of S company limited as on 31st December 2008

Liabilities	Rs		Assets	Rs.
Equity shares Rs. 100 each	3,00,000		Cash in hand	2,000
8% Preference shares Rs. 100 each	1,50,000		Cash at bank	20,000
General reserve	40,000		Sundry Debtors	80,000
Profit & Loss account	10,000		Stock	1,40,000
Bank Loan	50,000		Land & Buildings	2,05,000
Sundry Creditors	15,000		Furniture	30,000
			Goodwill	70,000
			Discount on shares	18,000
	5,65,000			**5,65,000**

The following are the methods for determining asset value:

(i) Furniture will be depreciated at a rate of 10%.

(ii) The estimated value of stock, land and buildings, and goodwill is Rs. 1,20,000, Rs. 2,50,000, and Rs. 80,000, respectively.

(iii) Debtors are expected to receive 80% of book value.

Determine the worth of equity shares.

Further Readings

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Unit 08: Cash Flow Statement

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Meaning of cash flow statement
- Methods of preparation of cash flow statement;
- Factors affecting the inflows and outflows of cash;
- Accounting treatment of cash flow statement

Introduction

Until now, you have learned about financial statements, which are primarily comprised of a Position Statement (showing an enterprise's financial position as of a specific date) and an Income Statement (showing the result of the operational activities of an enterprise over a particular period). A third important financial statement is the cash flow statement, which shows the inflows and outflows of cash and cash equivalents. This statement is typically prepared by businesses and serves as a tool in the hands of users of financial information to learn about an enterprise's sources and uses of cash and cash equivalents over time from various activities. Because of its practical utility to users of financial information, it has grown in prominence over the last decade. Companies' financial statements are prepared in accordance with the accounting standards outlined in the Companies Act of 2013. Accounting Standards are mandatory in nature and are notified under Section 133 of the Companies Act, 2013 through the Accounting Standards Rules, 2006. The Companies Act of 2013 also states that if accounting standards are not followed, financial statements will not be true and fair, which is a financial statement quality. Companies Act, 2013 (Section 2 (40)] defines financial statements as including a cash flow statement prepared in accordance with Accounting Standard- 3 (AS-3)- Cash Flow Statement. A cash flow statement summarizes an enterprise's historical changes in cash and cash equivalents by categorizing cash flows as operating, investing, or financing. It requires that an enterprise prepare and present a cash flow statement for each accounting period for which financial statements are presented. This chapter discusses and explains how to prepare a cash flow statement for an accounting period.

8.1 Objectives of Cash Flow Statement

A Cash flow statement shows inflow and outflow of cash and cash equivalents from various activities of a company during a specific period. The primary objective of cash flow statement is to provide useful information about cash flows (inflows and outflows) of an enterprise during a particular period under various heads, i.e., operating activities, investing activities and financing activities. This information is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

8.2 Benefits of Cash Flow Statement

- A cash flow statement, when used in conjunction with other financial statements, provides information that enables users to evaluate changes in an enterprise's net assets, its financial structure (including its liquidity and solvency), and its ability to affect the amounts and timings of cash flows in order to adapt to changing circumstances and opportunities.
- Cash flow information is useful in assessing an enterprise's ability to generate cash and cash equivalents, and it allows users to develop models to assess and compare the present value of different enterprises' future cash flows.
- It also improves the comparability of different enterprises' reporting of operating performance because it eliminates the effects of using different accounting treatments for the same transactions and events. It also aids in balancing its cash inflow and cash outflow in response to changing conditions. It is also useful for verifying the accuracy of previous forecasts of future cash flows and investigating the relationship between profitability and net cash flow, as well as the impact of changing prices.

8.3 Cash and Cash Equivalents

As previously stated, a cash flow statement shows the inflows and outflows of cash and cash equivalents from an enterprise's various activities over a given period. AS-3 defines 'cash' as cash in hand and demand deposits with banks, while 'cash equivalents' are short-term highly liquid investments that are readily convertible into known amounts of cash and are subject to a minor risk of value change. A cash equivalent investment is one that has a short maturity, such as three months or less from the date of acquisition. Unless they are substantial cash equivalents, investments in shares are excluded from cash equivalents. Preference shares of a company, for example, acquired shortly before their specific redemption date.

8.4 Cash Flows

It refers to the movement of money in and out of a business as a result of non-cash items. Cash receipt from a non-cash item is referred to as cash inflow, while cash payment for such items is referred to as cash outflow. For example, purchasing machinery with cash is a cash outflow, whereas receiving proceeds from the sale of machinery is a cash inflow. Other examples of cash flows include cash collection from trade receivables, payment to trade payables, payment to employees, dividend and interest payments, and so on. Excess cash is invested in cash equivalents as part of cash management. As a result, the purchase of marketable securities or short-term investments that constitute cash equivalents is not taken into account when preparing the cash flow statement.

8.5 Classification of Activities for Cash Flow Statement

You are aware that various business activities generate cash flows (inflows or receipts and outflows or payments), which are the subject of a cash flow statement. According to AS-3, these activities are to be classified into three categories:

1. Operating,
2. Investing, and
3. Financing activities, so that the cash flows generated (or used) by (in) these activities can be shown separately. This enables cash flow statement users to assess the impact of these activities on an enterprise's financial position as well as its cash and cash equivalents.

Cash from Operating Activities-These are the activities that comprise of an enterprise's primary or main activities. For example, for a clothing company, operating activities include raw material procurement, manufacturing expenses, garment sales, and so on. These are the enterprise's primary revenue-generating activities (or the main activities), and they are not investing or financing activities. The amount of cash from operations' indicates the company's internal solvency level, and is regarded as the key indicator of the extent to which the enterprise's operations have generated sufficient cash flows to maintain the enterprise's operating capability, pay dividends, make new investments, and repay loans without recourse to external sources of financing.

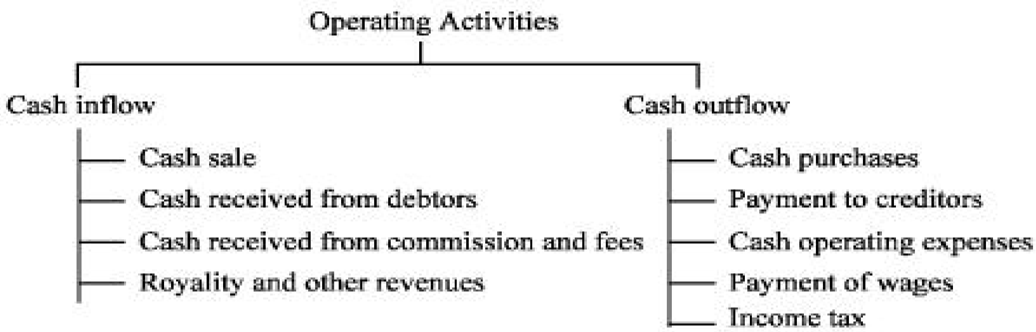
Inflows of cash from operating activities –

- Cash receipts from the sale of goods and the provision of services.
- Royalties, fees, commissions, and other revenues in cash

Cash outflows from operations-

- Cash payments to suppliers for goods and services,
- Cash payments made to and on behalf of employees,
- Payments made to an insurance company in cash for premiums and claims, annuities, and other policy benefits,

Income tax payments in cash, unless specifically associated with financing and investing activities.



In the case of operating cash flows, the net position is shown. An enterprise may hold securities and loans for the purpose of dealing or trading. In either case, they represent inventory held for resale. As a result, cash flows resulting from the acquisition and disposition of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial institutions are typically classified as operating activities because they are related to the primary activity of that institution.

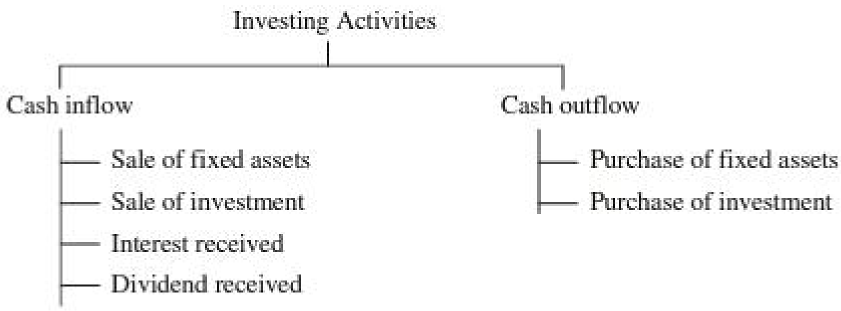
Cash from Investing Activities-AS-3 defines investing activities as the acquisition and disposition of long-term assets and other investments that are not cash equivalents. Investing activities involve the purchase and sale of long-term or fixed assets such as machinery, furniture, land, and buildings, among other things. Long-term investment transactions are also considered investing activities. Separate disclosure of cash flows from investing activities is important because it represents the amount of money spent on resources that will generate future income and cash flows. Examples of cash flows generated by investing activities include:

Cash Outflows from investing activities-

- Cash payments for fixed assets, including intangibles, and capitalized R&D
- Other than instruments held for trading purposes, cash payments to acquire shares, warrants, or debt instruments of other enterprises
- Cash advances and loans to third parties (other than advances and loans made by a financial enterprise wherein it is operating activities).

Cash inflows from investing activities-

- Cash received from the sale of fixed assets, including intangibles
- Receipt of funds from the repayment of third-party advances or loans (except in case of financial enterprise)
- Cash received from the sale of other enterprises' shares, warrants, or debt instruments, excluding those held for trading purposes
- Cash interest received from loans and advances.
- Receipt of dividend from investing company.



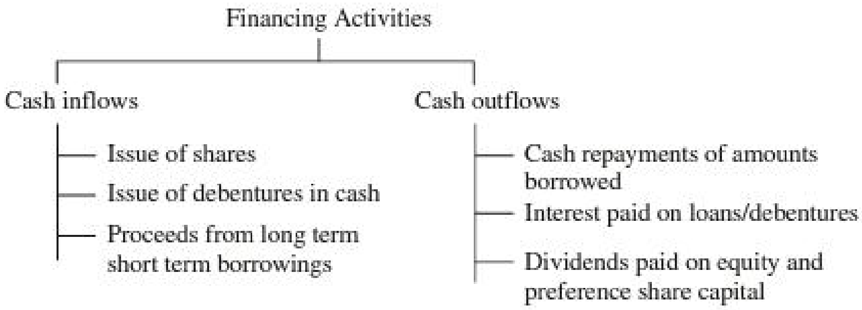
Cash from Financing Activities-Financing activities, as the name implies, concern long-term funds or capital of an enterprise, such as cash proceeds from the issuance of equity shares, debentures, raising long-term bank loans, repaying bank loans, and so on. According to AS-3, financing activities are those that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and the enterprise's borrowings. Separate disclosure of cash flows arising from financing activities is important because it aids in predicting claims on future cash flows by providers of funds to the enterprise (both capital and borrowings). Here are some examples of financing activities:

Cash Inflows from financing activities

- Cash proceeds from the issuance of shares (equity or preference).
- Cash proceeds from the issuance of debentures, loans, bonds, and other short- and long-term borrowings.

Cash Outflows from financing activities-

- Cash proceeds from the issuance of shares (equity or preference).
- Cash proceeds from the issuance of debentures, loans, bonds, and other short- and long-term
- borrowings.



It is important to note that a transaction may contain cash flows that are classified differently. For example, if an installment paid in respect of a fixed asset acquired on a deferred payment basis includes both interest and loan, the interest component is classified as financing activities and the loan component as investing activities. Furthermore, the same activity may be classified differently for different businesses. For example, purchasing shares is an operating activity for a stock brokerage firm, whereas it is an investing activity for other businesses.

Treatment of Some Peculiar Items-

Extraordinary Items-Extraordinary items are not a common occurrence, such as theft, earthquakes, or floods. Because extraordinary items are non-recurring, cash flows associated with them should be classified and disclosed separately as arising from operating, investing, or financing activities. This is done so that users can understand their nature and impact on an enterprise's current and future cash flows.

Interest and Dividends-In the case of a financial enterprise (whose primary business is lending and borrowing), interest paid, interest received, and dividend received are classified as operating activities, whereas dividend paid is classified as a financing activity. According to AS-3, in the case of a non-financial enterprise, payment of interest and dividends is considered more appropriate as financing activities, whereas receipt of interest and dividends is considered investing activities.

Taxes on Income and Gains-Income tax (tax on normal profit), capital gains tax (tax on capital profits), and dividend tax are all examples of taxes (tax on the amount distributed as dividend to shareholders). Cash flows resulting from income taxes must be separately disclosed and classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities, according to AS-3. This clearly implies that operating cash flows should include tax on operating profit.

Dividend tax, i.e., dividend tax paid, should be classified as financing activity in addition to dividend paid.

Capital gains taxpaid on the sale of fixed assets should be included in the definition of investing activities.

Non-cash Transactions-Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement, according to AS-3. Examples of such transactions include the acquisition of machinery through the issuance of equity shares and the redemption of debentures through the issuance of equity shares. Such transactions should be disclosed elsewhere in the financial statements in such a way that all relevant information about these investing and financing activities is provided. As a result of the non-cash nature of the transaction, assets acquired through the issuance of shares are not disclosed in the cash flow statement.

8.6 Method of Preparing Cash Flow Statement

The Cash Flow Statement can be prepared in two ways. Both methods produce the same final total as well as sub-totals for the three sections - operating, investing, and financing. They only differ in how the information about cash flow from operating activities is presented.

Direct Method Format:

Cash Flow from Operating Activities:		
Receipts:		
Collections from customers	$xxxx	
Interest Received	xxxx	
Dividends Received	xxxx	
Total Cash Receipts		$ xxxxx
Payments:		
To suppliers	($xxxx)	
To employees	(xxxx)	
For Interest	(xxxx)	
For Income Tax	(xxxx)	
Total Cash Payments		(xxxxx)
Net Cash Flow from Operating Activities		$ xxxxx
Cash Flow from Investing Activities:		
Acquisition of plant assets	($xxxx)	
Loan to another company	(xxxx)	
Proceeds from sale of investments	xxxx	
Proceeds from sale of plant assets	xxxx	
Collection of loans	xxxx	
Net Cash Flow from Investing Activites		xxxxx
Cash Flow from Financing Activities:		
Proceeds from issuance of Note Payable	$xxxx	
Proceeds from issuance of stock	xxxx	
Payments on Notes Payable	(xxxx)	
Dividends Paid	(xxxx)	
Purchase of Treasury stock	(xxxx)	
Net Cash Flow from Financing Activities		(xxxxx)
Net Increase (Decrease) in Cash		$xxxxx
Cash Balance, Beginning of Period		xxxxx
Cash Balance, End of Period		$xxxxx

Indirect Method Format:

Cash Flow from Operating Activities:		
Net Income	$xxxx	
Add (Subtract) items that affect net income and cash flows differently:		
Depreciation, Depletion, Amortization (+)	xxxx	
Gain on sale of plant asset (-)	(xxxx)	
Loss on sale of plant asset (+)	xxxx	
Decrease in current assets (+)	xxxx	
Increase in current assets (-)	(xxxx)	
Increase in current liabilities (+)	xxxx	
Decrease in current liabilities (-)	(xxxx)	
Net Cash Flow from Operating Activities		$ xxxx
Cash Flow from Investing Activities:		
	$ xxxx	
Same format as direct method		
	(xxxx)	
Net Cash Flow from Investing Activities		xxxx
Cash Flow from Financing Activities		
	$ xxxx	
Same format as direct method		
	(xxxx)	
Net Cash Flow from Financing Activities		xxxx
Net increase (decrease) in cash		$ xxxx
Cash Balance, Beginning of the period		xxxx
Cash Balance, End of the period		$ xxxx

Some Cash Flow Statement Facts:

(i) Only publicly traded companies are required to prepare and present a Cash Flow Statement.

(ii) The Cash Flow Statement is prepared during the same accounting period as the Profit and Loss Account and Balance Sheet.

(iii) Cash flow items are as follows:

(a) Operating cash flow:

(b) Cash flow from investing;

(c) Cash flow from financing.

(iv) Operating activities include non-investment and non-financing revenue-generating activities.

(v) There are two methods for calculating cash flow from operating activities: direct and indirect.

Only the indirect method is recommended by the IFRS Guidelines.

Calculation of operating Activities-Cash flow from operating activities is primarily derived from the enterprise's primary revenue generating activities. Among the cash flows generated by operating activities are:

1. Cash receipts from the sale of goods and the provision of services.
2. Revenue from royalties, fees, commissions, and other sources.
3. Payments in cash to suppliers for goods and services.
4. Cash payment to employees
5. Cash payment or tax refund

Stage 1: Determine operating profit before changes in working capital in the following manner.

Operating Activities- Cash flow from operating activities is primarily derived from the enterprise's main revenue generating activities. Among the cash flows from operating activities are:

i. Cash received from the sale of goods and the provision of services.
ii. Cash receipts from royalties, fees, commissions, and other sources.
iii. Cash payments to suppliers for goods and services.
iv. Cash payments to employees
v. Cash payment or refund of income tax.

The first stage, calculating operating profit before working capital changes, can be done as follows.

Net profit before Tax and extra ordinary Items	xxx	
Add Non-cash and non operating Items		
which have already been debited to profit and Loss Account i.e.		
Depreciation	xxx	
Amortisation of intangible assets	xxx	
Loss on the sale of Fixed assets.	xxx	
Loss on the sale of Long term Investments	xxx	
Provision for tax	xxx	
Dividend paid	xxx	xxx
		xxx
Less : Non-cash and Non-operating Items which have already been credited to Profit and Loss Account i.e.		
Profit on sale of fixed assets	xxx	
Profit on sale of Long term investment	xxx	xxx
Operating profit before working Capital changes.		xxx

Stage-2

Adjust the increase or decrease in current assets and current liabilities after obtaining operating profit before working capital changes as per stage I. When adjusting current assets and current liabilities, the following general rules may be applied.

A. Short-term assets-

(i) An increase in a current asset reduces cash inflow because cash is blocked in current assets.

(ii) A decrease in a current asset increases cash inflow because cash is released from the sale of current assets.

B. Current liabilities-

(i) An increase in a current liability decreases cash outflow because cash is saved.

(ii) A decrease in a current liability item causes an increase in cash outflow due to liability payment. Thus,

Cash from operations = operating profit before working capital changes + Net decrease in current assets + Net Increase in current liabilities – Net increase in current assets – Net decrease in current liabilities.

Example 1

The net income reported in the Income Statement for the year was Rs. 110,000, and fixed asset depreciation was Rs. 44000. The following are the balances of current assets and current liabilities at the beginning and end of the year. Determine the cash flow from operating activities.

	End of the year Amount (Rs.)	Beginning of the year Amount (Rs.)
Current Items		
Cash	130,000	140,000
Debtors	200,000	180,000
Inventories	290,000	300,000
Prepaid expenses	15,000	16,000
Account payables	102,000	1,16,000

Solution-

Cash from operating Activities

Details		Amount (Rs.)
Net Income		1,10,000
Adjustment for non cash and Non-operating items		
Add Depreciation		44,000
Operating Profit before working capital changes		154,000
Current Assets :		
Add : (a) Decrease in inventories	10,000	
(b) Decrease in prepaid expenses	1000	11000
		165,000
Deduct : (a) Increase in Debtors	(20,000)	
Current liabilities		
(b) Decrease in Account payables	(14,000)	34,000
Net Cash flow from operating Activities		131,000

Calculation of Investing Activities

Investing Activities are transactions involving the purchase and sale of long-term assets and investments.

1. Cash payments to acquire fixed assets are an example of cash flow generated by investing activities.

2. Cash proceeds from the sale of fixed assets
3. Cash payments for stock or debenture investment
4. Cash receipts from the repayment of third-party advances and loans

Thus, cash inflows from investing activities include:-

- Cash sales of plant and machinery, land and buildings, furniture, goodwill, and so on.
- Cash sales of investments made in other companies' shares and debentures.
- Cash receipts from collecting the principal amount of third-party loans.

Cash outflows from investing activities include:-

- The purchase of fixed assets such as land, buildings, furniture, and machinery.
- Purchase of intangible assets such as goodwill, trademarks, and so on.
- Acquisition of shares and debentures
- Acquisition of Government Bonds , Loan to a third party

Example 2- Determine the cash flow from investing activities using the following data.

Particulars	Opening	Closing
Machinery (at cost)	400,000	420,000
Accumulated Depreciation	100,000	110,000
Patents	280,000	160,000

Additional Information:

(i)During the year, a machinery costing Rs 40,000 with this accumulated depreciation of Rs 24000 was sold for Rs 20,000.

(ii)Patents were written off to the tune of Rs 40,000, and some patents were sold at a profit of Rs 20,000.

Solution.

Solution: Cash Flow from Investing Activities

Cash Flow from Investing Activities

Particulars	Rs
Inflow from sale of machinery	20,000
Inflow from sale of patent (2)	100000
	120000
Outflow on purchase of machinery (1)	(60000)
Net cash flow from investing activities	60000

Working notes

Machinery A/c

Balance b/d	400000	Bank (Inflow)	20,000
Profit and Loss A/c	4000	Accumulated depreciation	24000
(Profit on sale of machine)		(Depreciation on machinery sold)	
Bank A/c	60000	Balance c/d	420000
	464000		464000

Patent A/c

Balance b/d	280000	Bank A/c (Inflow)	100000
Profit and Loss A/c	20000	Balancing figure	40000
(Profit)		Profit and Loss A/c	160000
		Balance c/d	
	300000		300000

Calculation of Financing Activities-The third section of the cash flow statement reports the cash paid and received from non-current or long-term liabilities as well as shareholder capital.

Cash proceeds from the issuance of shares or other similar instruments are examples of cash flow resulting from financing activities.

- Proceeds from the issuance of debentures, loans, notes, bonds, and other short-term borrowings in cash

- Repayment of borrowed funds in cash

Financing activities generate cash inflows.

- Cash-only issue of equity and preference share capital

- Cash-only issuance of debentures, bonds, and long-term notes

Payment of dividends to shareholders- Redemption or repayment of loans such as debentures and bonds- Redemption of preference share capital- Buy back of equity shares are examples of cash outflows from financing activities.

Example 3**-** Calculate the Cash from financing activities from the following information:

From the following information. Calculate the Cash from financing activities:

	31.12.2006	31.12.2007
Particulars	Rs	Rs
Equity share capital	400,000	500,000
10% debentures	150,000	100,000
Securities premium	40000	50000

Additional Information : Interest paid on debentures Rs10000.

Solution. Calculation of Cash from financing activities

Particulars	Rs	
Cash proceeds from the issue of shares (Including premium)		110000
Interest paid on debenture	10000	
Redemption of debenture	50000	60,000
		50,000

Prepare a cash flow statement for the fiscal year ended December 31, 2006, using the indirect method, using the summarized cash account of ABC Limited (Ltd.). The company has no cash equivalents:

Summarised Cash A/c

Particulars	Amount (Rs. 000)	Particulars	Amount (Rs. 000)
Balance on 1.1.2006	50	Payment to Suppliers	2000
Issue of equity shares	300	Purchase of fixed assets	200
Receipts from customers	2800	Overhead expenses	200
Sale of fixed assets	100	Wages and salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.12.2006	150
	3250		3250

Additional information : Net profit before tax for the year 2006 was Rs 500000.

Solution :

Cash flow statement of ABC Ltd
for the year ended 31st December 2006 (Indirect method)

	Rs 000	Rs 000
A. Cash flow from operating activities		
Net profit before tax	500	
Income tax paid	(250)	
Net cash from operating activities		250
B. Cash flow from investing activities		
Purchase of fixed assets	(200)	
Sale of fixed assets	100	
Net cash used in investing activities		(100)
C. Cash flow from financing activities :		
Issue of equity shares	300	
Repayment of bank loan	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash (A+B+C)		100
(Net cash inflow from activities)		

Cash flow statement limitations Although the cash flow statement is very useful nowadays and serves many purposes. However, when using this vital tool, certain precautions must be taken. The reason for this is that incorrectly relating net income figures to cash flow can lead to misleading conclusions. The following are some of the major limitations of the Cash Flow Statement:

It is extremely difficult to define the term "cash."

There are disagreements about whether or not certain items, such as cheques, stamps, and postal orders, should be included in cash.

As the current business transitions from cash to accrual accounting, prepaid and credit transactions may be represented as an increase in working capital, and equating net income to cash flow would be misleading because a number of non-cash items would affect net income.

Summary

- The cash flow statement is concerned with the flow of cash, which includes both cash equivalents and cash.
- A cash flow statement summarises cash receipts and disbursements over a specific time period.
- There are two approaches to creating a cash flow statement: I The direct method; (ii) the indirect method
- The cash flow statement displays three types of cash inflows and outflows. Specifically, there are three types of activities: I operating activities, (ii) investing activities, and (iii) financing activities.
- The enterprise's revenue-generating activities are known as operating activities.
- Investing activities include the purchase and sale of long-term assets as well as other investments not included in cash and its equivalents.

- Financing activities are those that result in a change in the size and composition of the enterprise's share capital and borrowings.
- Cash flows from extraordinary items must be reported separately as operating, investing, and financing activities.

Keywords

- Cash flow statement
- Operating activity
- Investing activity
- Financing activity
- Extra ordinary item

Self Assessment

1. The cash flow statement includes

A. Financing Operations

B. Business Operations

C. Investing Actions

D. All of these

2. Identify the objectives of Cash Flow Statement?

A. Analysis of cash position

B. Short-term cash planning

C. Evaluation of liquidity

D. All of the above

3. Cash Flow Statement is also known as ____________?

A. Statement of Changes in Financial Position on Cash basis

B. Statement accounting for variation in cash

C. Both a and b

D. Income Cash Statement.

4. In cash flow statement, where the item of interest received usually is shown?

A. Operating Activities

B. Financing Activities

C. Investing Activities

D. Financing Activities and Investing Activities

5. Cash Flow Statement is based upon _____?

A. Cash basis of accounting

B. Accrual basis of accounting

C. Credit basis of accounting

D. All of the above

6. Where the amount of operating expenses which are actually been paid in cash is shown?
A. Cash flow from sales
B. Cash outflow on purchases
C. Cash outflow on expenses
D. Cash flow from purchase

7. While preparing Cash Flow Statement, tell the option where non-cash items and non-operating items are required to be adjusted?
A. Indirect method
B. Direct method
C. Both a & b
D. None of the above

8. _______________ is cash flow from operating activities?
A. Cash Receipts from customers
B. Purchase of fixed assets
C. Sale of fixed assets
D. Dividend Paid

9. What is the basis of Cash Flow Statement preparation?
A. Profit and loss account
B. Balance Sheet
C. Additional Information
D. All of the above

10. What is the effect if a company issues stocks and bonds for raising of funds?
A. Decrease in Cash
B. Increase in Cash
C. Increase in Equity
D. Increase in Liabilities

11. Tell the example of cash flow from a financing activity?
A. Payment of Dividends
B. Receipt of Dividend on Investment
C. Cash Received from Customers
D. Purchase of Fixed Asset

12. Tell the example of cash flow from a operating activity?
A. Payment of Dividends
B. Receipt of Dividend on Investment
C. Cash Received from Customers
D. Purchase of Fixed Asset

13. Tell the example of cash flow from a investing activity?
A. Payment of Dividends
B. Receipt of Dividend on Investment
C. Cash Received from Customers
D. All of these

14. Which of following item comes under financial activities of company?
A. Redemption of Debenture
B. Issue of Preference Share
C. Interest Paid on long term loan
D. All these

15. Who are interested in the cash flow statements of an organization?
A. Directors
B. Shareholders
C. Investors of the company
D. All of these

Answer for Self Assessment

1.	D	2.	D	3.	C	4.	C	5.	A
6.	C	7.	A	8.	D	9.	D	10.	B
11.	A	12.	C	13.	B	14.	D	15.	D

Review Questions

1. What exactly is a Cash Flow Statement? Describe the main goals of the cash flow statement.
2. Specify cash in accordance with AS-3 (revised). When preparing a cash flow statement, how are the various activities classified according to AS-3 revised?
3. Describe three operational activities.
4. Explain two examples of investment activities.
5. The comparative balance sheets of Anjali Ltd. as of March 31, 2007 are presented below.

Details	2007 Amount (Rs)	2006 Amount (Rs)
Cash	40000	57000
Account Receivables	77000	64000
Inventory	132000	140000
Prepaid expenses	12140	16540
Land	125000	150000
Equipment	200000	175000
Accumulated Depreciation (Equipment)	(60000)	(42000)
Building	250000	250000
Accumulated Depreciation (Building)	(75000)	(50000)
	701140	760540
Account payables	33000	45000
Bond payables	235000	265000
Equity share capital (Rs 10 per share)	280000	250000
Retained earnings	153140	200540
	701140	760540

Further Readings

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Unit 09: Amalgamation I

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- meaning of amalgamation
- types of amalgamation
- methods of purchase consideration
- accounting treatment amalgamation in the nature of merger

Introduction

In a "Amalgamation," two or more companies merge into one by "Merging" (or) "Taking Over" the other company. As a result, the term Amalgamation refers to two types of activities:

a) Two or more companies merge to form a new company.

b) One company absorbs or blends with another.

As a result, amalgamation includes absorption.

There is a sale and a purchase taking place in an amalgamation. As a result, the books of the Selling Company must be closed and the books of the Purchasing Company must be opened.

- Transferor Company refers to the Selling Company

- Purchasing Company is referred to as the Transferee Company

Amalgamation Types - According to Accounting Standards AS-14, there are two types of amalgamations:

- Amalgamation in the Form of Merger
- Amalgamation in the Form of a " Purchase "

9.1 Introduction and types of Amalgamation

Amalgamation: When two or more companies that exist as on date combine together to form a new company, then it is called "amalgamation".

In this case, all the combining companies will get liquidated. A new company will be formed to take over their business.

To illustrate, X Ltd. and Y Ltd., the two existing companies, combine together to form Z Ltd., a new company. X Ltd. and Y Ltd. will get liquidated. A new company Z Ltd. is formed to run the business.

Absorption: When one existing company takes over the business of two or more older existing companies, it is called "absorption". The other two or more existing companies (i.e., companies whose business are taken over) will get liquidated. At the same time, no new company will be floated.

To illustrate, X Ltd., one existing company, takes over other two existing companies Y Ltd. and Z Ltd. Y Ltd. and Z Ltd. will get liquidated. X Ltd. continues to do its business and no new company will be formed. In other words, X Ltd. absorbs the other two companies Y Ltd. and Z Ltd. X Ltd. continues to do its business whereas Y Ltd. and Z Ltd. will be liquidated.

External reconstruction: When an existing company is liquidated and in its place a new company is floated but with the same shareholders, it is known as "external reconstruction". Shareholders will remain unaltered but company's name and structure will be new.

To illustrate, X Ltd. is liquidated. But the existing shareholders continue their status as shareholders and a new company Y Ltd. is formed.

9.2 Legal Basis

The Companies Act, 1956 remain silent on this, i.e., the term "amalgamation" has not been definedspecifically. However, the Courts have interpreted the term to include amalgamation as well as absorption.

In S. Somayajulu vs. Hop Prudhommee and Company Ltd., (1963, Com. L.J61), amalgamation has beendefined as "a state of things under which either two companies are joined so as to form a third entity or oneis absorbed into or blended with another".

According to Halsburg's laws of England, amalgamation is a blending of two or more existingundertakings into one undertaking, the shareholders of each blending company becoming substantially theshareholders of the company which is to carry on the blended undertakings. There may be amalgamationeither by transfer of two or more undertakings to a new company or by the transfer of one or moreundertakings to an existing company.

Sections 390 to 396(A) of the Companies Act envisage certain provisions relating to amalgamation.Accordingly, any scheme of amalgamation necessitates the approval of the Court. The Court wieldsenormous powers on this matter.

Section 494 of the Companies Act facilitates amalgamation, absorption and reconstruction of acompany. It provides that the liquidator of a company can accept shares, policies or other like interestsin the transferee company for distribution among the members of the transferor company, provided, thefollowing two conditions are satisfied:

(i) A special resolution is passed by the Company to the effect

(ii) The liquidator purchases the interest of any dissenting member at a price to be determined byagreement or by arbitration

9.3 Accounting Basis

Accounting for amalgamation: Standard AS-14, issued by the Institute of Chartered Accountants of India,deals with the accounting for amalgamation and the treatment of any resultant goodwill or reserves. Thisstandard was issued in 1994. This is mandatory to all companies with effect from the accounting yearcommencing on or after 1 April 1995.

According to AS-14, amalgamation means an amalgamation pursuant to the provisions of the CompaniesAct 1956, or any other statute which may be applicable to companies.

The Standard uses the term "transferor company" for the company which is amalgamated into anothercompany.

The Company selling its business is also called "vendor company".The Company into which a transferor company is amalgamated is called "transferee company".The Company which acquires the business is also called the "vendee company".It is important to note that:

(i) The term amalgamation includes "absorption" also

(ii) The term amalgamation does not apply to acquisitions in the nature of controlling interest (Becausein such cases, the acquired company will not be dissolved and its separate entity will continue toexist)

Types of amalgamation

The Standard AS-14 classifies amalgamation into two categories:

1. Amalgamation in the nature of merger

2. Amalgamation in the nature of purchase

Amalgamation in the Nature of Merger

Amalgamation should be considered to be an amalgamation in the nature of merger if the followingconditions are satisfied:

1. All the assets and liabilities of the transferor company become the assets and liabilities of the transfereecompany after amalgamation.

2. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company(other than equity shares already held therein, immediately before the amalgamation of the transfereecompany or its subsidiaries or their nominees) become equity shareholders of the transferee companyby virtue of an amalgamation.

3. The consideration to the shareholders of the transferor company (willing to become equity shareholdersof the transferee company) is discharged by the transferee company wholly by issue of equity shares inthe transferee company except that cash may be paid in respect of any fractional shares.

4. The business of the transferee company is intended to be carried on after amalgamation by the transfereecompany.

5. No adjustment is intended to be made to the book values of the assets and liabilities of the transferorcompany when they are incorporated in the financial statements of the transferee company except toensure uniformity of accounting policies.

Amalgamation in the Nature of Purchase

The amalgamation is in the nature of purchase, if any one or more of the conditions stipulated for themerger are not satisfied.Hence, in the amalgamation in the nature of purchase:

1. Selling company's business will not be carried on in future

2. Shareholders holding 90% of the transferor company will not become shareholders of the transfereecompany

3. All the assets and liabilities of the selling company will not be taken over by the transferee company

4. Consideration payable to shareholders of transferor company may be in the form of shares or cash or inany other agreed form

5. Assets and liabilities taken over by the transferee company may be shown at values other than bookvalues at the discretion of the transferee company

NOTE: Transferor company is the "selling company" and transferee company is the "purchasing company".The Accounting Standard, for the purpose of accounting, recommends the "pooling of interests method"in the case of "amalgamation in the nature of merger" and the "purchase method" for "amalgamation in thenature of purchase". These methods will be discussed in detail later.

9.4 Purchase consideration and its Methods

In general, "purchase consideration" means the cash and non-cash payments made to the shareholdersof the transferor (vendor) company. Accounting Standard AS-14, issued by the ICA1, defines the termconsideration as, "Consideration for the amalgamation means the aggregate of shares and other securitiesissued and the payment made in the form of cash and other assets by the transferee company to theshareholders of the transferor company".

Salient Features of "Purchase Consideration"

The following are the salient features of purchase consideration:

1. Purchase consideration is confined to payments (cash and non-cash) to the shareholders of the transferorcompany (Selling company).

2. This amount payable has to be made by the transferee company which is to be treated as considerationfor the acquisition of business.

3. Any amount paid to debenture holders, creditors and cost of absorption should not be included inpurchase consideration.

4. Non-cash elements of purchase consideration should be determined at the fair value.

5. AS-14 recognizes the consideration payable to equity as well as preference shareholders of the transferorcompany.

Purchase Consideration Methods:

The following are the different methods of computing purchase consideration:

1. Lumpsum method

2. Net payments method

3. Net assets method

4. Ratio of exchange method

It is to be noted that as per AS-14, purchase consideration means only payment made to shareholders, irrespective of the method applied to compute purchase consideration.

1. **Lumpsum Method**

At times, the purchase consideration is mentioned (as a lump sum) straightaway in the agreement. In such a case, no necessity arises to compute purchase consideration.

2. **Net Payment Method**

Only those agreed payments specifi ed in the agreement have to be added to determine the purchase consideration. That means, the quantum of amount payable in cash or shares or debentures are all to be added. The aggregate of the amount is referred to as "net payment" made by the purchasing company. It has to be paid to shareholders of the selling company.

Some of the important factors to be observed while determining the purchase consideration are as follows:

1. Only the agreed amount specifi ed in the agreement should be included in the consideration.

2. In general, purchase consideration will not include payments to debenture holders and creditors. For this, a separate adjustment has to be made: such liabilities should be transferred to the books of the transferee company and then payment of liabilities should be shown in the books of the transferee company.

3. Liquidation expenses of the transferor company are met by the transferee company. Accountants differ in the treatment of liquidation expenses. If they are payable by the purchasing company, it is to be added to purchase consideration. But some accountants exclude the liquidation expenses in determining purchase consideration.

4. Shares issued by the transferee company should be valued at market price if the "purchase method" is adopted and at par value (fully paid only) if "the pooling of interests" method is adopted.

Example 1:

X Ltd. agrees to buy Y Ltd.'s business on the following terms:

1. The shareholders of Y Ltd. will be paid Rs. 25 in cash and offered four Rs. 10 shares in X Ltd. for each share in Y Ltd. As of the date of amalgamation, Y Ltd. had 50,000 equity shares outstanding.

2. Debenture holders holding 5,000 Rs. 100 debentures will be redeemed at a 10% premium.

3. Cost of liquidation amounting to Rs. 25,000 are to borne by X Ltd.

Determine the value of purchase consideration.

Solution-

Amount payable to Shareholders of Y Ltd.

1. Cash payment (Rs. 25 x 50,000) Rs. 12, 50,000

2. Shares Issued (50,000 x 4 x 10) Rs. 20, 00,000

Total purchase consideration Rs. 32, 50,000

Illustration 1: Model: Net payment method

X Ltd. agreed to take over the business of Y Ltd. on the following terms:

1. The shareholders of Y Ltd. are to be paid Rs.20 in cash and the offer of five shares of Rs.10 each in X Ltd. for every share of Y Ltd. Y Ltd. had 60,000 equity shares outstanding

2. The debenture holders holding 10,000 debentures of Rs.100 each are to be redeemed at a premium of 20%

3. Costs of liquidation amounting to Rs. 40,000 are to be borne by X Ltd. Compute the purchase consideration

Solution:

NOTE:

1. Debenture holders payment will be excluded.

2. Payment in cash and in shares have to be added.

3. Liquidation expenses are to be included, as they are to be borne by X Ltd.

Computation of Purchase Consideration (Under Net Payment Method)

Step 1: Cash Payment 60,000

Equity Shares × Rs.20 (Outstanding) (Given) 12,00,000

Step 2: Payment by Shares Shares

Issued 5 Shares for 1 Share

∴Total Shares = 5 × 60,000 = 3,00,000

Total Amount = 3,00,000 × 10	30,00,000
Step 3: Cash Payment for Liquidation Expenses:	40,000
Step 4: Purchase Consideration	
(Step 1 + Step 2 + Step 3):	42,40,000

3. Net Assets Method

This method will be used if the "net payment method" cannot be used. When payment made is not crystal clear for various items, this method can be used. That means, if some form of cash payment is missing in the problem, this method can be adopted.

Under this method, purchase consideration is to be determined by adding the agreed values of assets taken over and deducting the agreed value of liabilities. This can be put in the form of equation as:

Sum of value of net assets = Agreed value of assets taken over – Sum of agreed value of liabilities taken over

Some of the important factors to be observed while determining purchase consideration under this method are:

1. The term "Assets" includes cash and bank balances.

2. The term "Assets" excludes items such as preliminary expenses, profi t & loss A/c (Dr.), discount on issue of shares.

3. Items shown on the assets side of balance sheet under the head "Miscellaneous Expenditure" should not be included in the category of assets.

4. Any other asset specially mentioned as "not taken over" should not be included.

5. Similarly, liabilities not taken over should not be included.

6. All credit balances should be excluded.

7. Items shown on the liabilities side of the balance sheet under the head "Reserves & Surplus" should not be included.

8. Accumulated profits are not liabilities. They should be excluded.

9. Liabilities included are amounts to third parties.

10. Any "fund"—for example, workmen's savings, profit sharing fund, PF—should be included under liabilities category.

11. "Trade creditors" comprises only creditors and bills payable. All other liabilities such as tax payable overdraft, any outstanding expenses are not a form of liability.

Illustration 2: Model: Net assets method

The following is balance sheet of Maa Ltd. as on 31 March 2011:

Liabilities	₹	Assets	₹
5,000 Equity Shares of ₹ 100 Each Fully Paid	5,00,000	Fixed Assets	10,00,000
		Investments	2,00,000
General Reserve	7,00,000	Current Assets	3,00,000
Profit & Loss Account	1,50,000	Preliminary Expenses	1,80,000
Trade Creditors	2,00,000	Share Issue Expenses	1,20,000
Provision for Taxation	1,50,000		
Proposed Dividends	1,00,000		
	18,00,000		18,00,000

On the date of balance sheet, the company was taken over by Pappa Ltd. on the following terms:

(a) Fixed assets are revalued at Rs. 12,00,000

(b) Investments have a market value of Rs. 1,50,000

(c) Current assets are agreed at Rs. 3,50,000 for the purpose of absorption

(d) Pappa Ltd. has agreed to pay the tax liability, which is estimated at Rs. 1,75,000

(e) Dividends are to be paid before absorption by Maa Ltd.

Compute the purchase consideration.

Solution:

Step 1 : Assets Taken Over by Pappa Ltd.:

(i) Fixed Assets (Ref: Terms): 12,00,000

(ii) Investments (Ref: Terms): 1,50,000

(iii) Current Assets: 3,50,000

Less: Dividend Paid: 1,00,000 2,50,000

Step 2 : Add [(i) + (ii) + (iii)]: 16,00,000

Step 3 : Liabilities Taken Over:

(i) Trade Creditors 2,00,000

(ii) Tax Liability 1,75,000

Step 4 : Add [(i) + (ii)] 3,75,000 3,75,000

Step 5 : (Step 2 – Step 4)

Purchase Consideration}: 12,25,000

Purchase Consideration payable to the Shareholders of Maa Ltd. = Rs. 12,25,000.

This amount, i.e., Rs. 12,25,000, may be paid by Pappa Ltd. either in the form of cash or shares or debentures or in the combined form of cash and securities.

NOTE: As dividends are to be paid before absorption, the proposed dividend has to be deducted from current assets. It may also be shown as a liability to be deducted combined with other liabilities, if it is agreed to be taken over by Pappa Ltd.

4. **Share Exchange Method (or) Intrinsic Value Method**

Under this method, the purchase consideration is determined on the basis of the ratio in which the shares of the transferee company are exchanged with those of the transferor company. The ratio of exchange is to be decided on the basis of intrinsic or market value of the shares concerned.

To illustrate, X Ltd. merged with Y Ltd. and allotted 7 shares for every 25 shares held by shareholders of X Ltd. If a shareholder holds 500 shares in X Ltd., he receives in exchange 140 shares in Y Ltd

"(i.e., " 500/25 "× 7 = 140 shares) "

Intrinsic value =Assets Available for Equity Shareholder" /No. of equity shares

Then purchase consideration is determined by using the formula:

Purchase consideration = Number of shares issued to the shareholders of the transferor company× Intrinsic value of the shares of the transferee company

At this juncture, one has to understand how fractional shares will have to be treated. Take the case illustrated in the share exchange method above. One Mr. Khan holds 60 shares in X Ltd. He is entitled to have

At this juncture, one has to understand how fractional shares will have to be treated. Take the case illustrated in the share exchange method above. One Mr. Khan holds 60 shares in X Ltd. He is entitled to have (60 × 7)/25 = 16.8 shares. As shares will have to be issued in whole numbers only, 16 shares can be issued to him. Mr. Khan will have to be compensated in cash for 0.8 share. It is based on market price. The transferee company sells such shares at the market price and remits the proceeds to the shareholders of the transferor company.

Illustration 3:Model: Intrinsic value method & treatment of fractional shares

A Ltd. takes over B Ltd. in pursuance of the scheme of amalgamation and it was agreed that the shareholders of B Ltd. must be issued shares in A Ltd. and the exchange is to be determined on the basis of intrinsic values of the shares of the two companies concerned.

The capital of B Ltd. comprises 75,000 equity shares of Rs. 10 each. The intrinsic values were: A Ltd.: Rs.80 and B Ltd.: Rs. 50. In allotment, fractional shares are aggregate to 375. The market value of A Ltd. was Rs. 90. You are required to compute the purchase consideration payable to B Ltd.

Solution:

Step 1: Determine the Ratio of Exchange:

It Is Based in Intrinsic Value of Shares as per the Direction Given in the Question.

Intrinsic Value of Shares Ratio A:B = Rs. 80: Rs. 50, i.e., 8:5

Hence, the Ratio of Exchange Will be for Every 8 Shares of B, 5 Shares of A Ltd.

Step 2: Determine the Number of Shares to Be Issued by

A Ltd. = 75,000*5/8 = 46,875 Shares

Step 3: Actual Number of Shares to Be Issued Is Determined by Deducting Fractional

Shares, i.e., 46,875 – 375 = 46,500 Shares

Step 4: Determination of Purchase Consideration:

(i) Number of Shares to Be Issued × Intrinsic Value

46,500 × Rs. 80 = Rs. 37,20,000

(ii) Add: Fractional Shares

375 × Rs. 80 = Rs. 30,000

Total: Rs.37,50,000

But, according to established accounting procedure, 375 shares representing fractional shares will have to be sold at market price.

In this question, market price per share as given as Rs.90. Then the total amount

for fractional shares will be 375 × Rs.90 = Rs.33,750. This amount, Rs. 33,750, will be remitted to individual shareholders.

The shareholder will get his amount as per the fraction of the share he is entitled to.

To illustrate, if one Mr. X will be getting for his fractional share, say 0.6, 0.6 × Rs. 90 = Rs. 54, and if the other one, Y for his fractional share 0.3 will be getting 0.3 × Rs. 90 = Rs. 27 and so on. However, the total amount so remitted for fractional shares will be equal to Rs. 33,750.

9.5 Amalgamation in the Nature of Merger

Accounting treatment in the books of purchasing company is based on the nature of amalgamation. Accounting Standard AS-14 stipulates two methods of accounting for amalgamation:

1. Pooling of interest methods

2. Purchase method

When the amalgamation is in the nature of merger, the transferee company has to apply "pooling of interests method". When the amalgamation is in the nature of purchase, the transferee company has to apply "purchase method"

9.3.2.2.1 Pooling of Interests Method

Pooling of assets, liabilities, capital, reserves and business of both companies takes place in this method:

1. The assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (i.e., book values). That means no adjustment is made in the book values of assets and liabilities of the transferor company. Further, fi ctitious assets are not assets and hence should not be incorporated in the books of transferee company.

2. The effects on the fi nancial statements of any changes in accounting policies are to be reported as perAS-5.

3. The purchase consideration under this method is to be valued at par value of shares issued.

4. The balance in the profi t and loss account of the transferor company should be aggregated with thecorresponding balance of the transferee company or transferred to general reserve.

5. The difference between the amount recorded as share capital issued + additional consideration inform of cash or other assets and the amount of share capital is to be adjusted in reserves in fi nancialstatements of the transferee company.

The Expert Advisory Committee of ICAI Recommends:

(a) The difference between the issued share capital of the transferee company and share capital oftransferor company should be treated as CAPITAL RESERVE.

(b) Reserve created on amalgamation is not available for dividend and/or bonus shares issued.

Journal Entries in the Books of Transferee Company

(Pooling of Interest Method)

Date	**Particulars**	**Lf**	**Dr.**	**Cr.**
	Step 1: Purchase of Business: Business Purchase A/c Dr. (With the Amount of Purchase Consideration.) To Liquidators of Transferor Company			
	Step 2: Take Over of the Assets, Liabilities and Reserves of the Transferor Company: Sundry Assets A/c (Individually) Dr. To Sundry Liabilities A/c (Individually)			

	To Profit and Loss A/c To Reserves A/c (Individually) To Business Purchase A/c [Note: All assets and liabilities are to be recorded at their book values separately. But at times, book value gets adjusted according to the accounting policy of purchasing company.]			
	Step 3: Settlement of Purchase Consideration: (i) When Shares Are Issued at Par: Liquidators of Transferor Company A/c Dr. To Equity Share Capital A/c To Preference Share Capital. A/c To Bank A/c (ii) When Shares Are Issued at Premium: Liquidators of Transferor Company A/c Dr. To Equity Share Capital A/c To Preference Share Capital A/c To Securities Premium A/c To Bank A/c			
	Step 3: Settlement of Purchase Consideration: (iii) When Shares Are Issued at Discount: Liquidators of Transferor Company A/c Dr. Discount on Issue of Shares A/c Dr. To Equity Share Capital A/c To Preference Share Capital A/c To Bank A/c			
	Step 4: Discharge of Liabilities: (i) When Debentures Are Issued at Par: Debentures of Transferor Company A/c Dr. To Debentures (of Transferee Company) A/c (ii) When Debentures Are Issued at Premium: Debentures of Transferor Company A/c Dr. To Debentures (of Transferee Company) A/c To Securities Premium A/c			
	Step 4: Discharge of Liabilities: (iii) When Debentures Are Issued as Discount: Debentures of Transferor Company A/c Dr. Discount on Issue of Debentures A/c Dr.			

	To Debentures (of Transferor Company) A/c			
	Step 5: Liquidation Expenses: (i) Liquidation Expenses A/c Dr. To Bank A/c (ii) General Reserve/P&L A/c Dr. To Liquidation Expenses A/c			
	Step 6: Formation Expenses: Preliminary Expenses A/c Dr. To Bank A/c [Note: At times, preliminary expenses are not written off against general reserve or P&L A/c. In such cases, it will be shown on the assets side of B/S under "Miscellaneous Expenditure".]			

2. Purchase Method

Accounting for amalgamation: When amalgamation is in nature of purchase, "purchase method" will have to be applied, in accordance with AS-14.

Accounting Entries in the Books of Transferee Company

(Purchase Method)

Date	Particulars	Lf	Dr	Cr
	Step 1: Business Purchase: (Purchase of Business) Business Purchase A/c Dr. To Liquidators of Transferor Company A/c **Step 2:** Taken Over of Assets of Liabilities: All Assets A/c (Individually) at Agreed Values Dr. To Liabilities A/c (Individually) at Agreed Values To Debentures in Vendor's Company A/c … To Business Purchase A/c			
	[Important Hints & Notes: Case 1: If total amount of credit accounts is greater than the total amount of debit accounts, the difference is to be treated as a capital loss and is to be debited to goodwill A/c. Then entry will be: **Goodwill A/c (Balancing Figure) Dr.** **Assets A/c (Individually) Dr.** **To Liabilities A/c (Individually)** **To Business Purchase A/c**			
	Case 2: On the other hand, if total amount of debit accounts is greater than the total amount of credit accounts, then the difference is to be treated as a capital profit and is to be credited			

	to capital reserve A/c. Then entry will be: Assets A/c (Individually) Dr. (Excluding Goodwill A/c) To Liabilities A/c (Individually) To Business Purchase A/c To Capital Reserve A/c (Balancing Figure)			
	Case 3: If there are both goodwill & capital reserve, then only net amount has to be shown in the B/S]. Step 3: Payment of Purchase Consideration: (i) When Securities Are Issued at Par: Liquidators of Transferor Company A/c Dr. To Bank A/c To Equity Share Capital A/c To Preference Share Capital A/c To Debentures A/c			
	(ii) When Securities Are Issued at Premium: Liquidators of Transferor Company A/c Dr. To Bank A/c To Equity Share Capital A/c ... To Preference Share Capital A/c ... To Debentures A/c ... To Securities Premium A/c			
	(iii) When Securities Are Issued at Discount: Liquidator of Transferor Company A/c Dr. Discount on Issue of Shares A/c Dr Discount on Issue of Debentures A/c Dr. To Bank A/c To Equity Share Capital A/c ... To Preference Share Capital A/c ... To Debentures A/c			
	Step 4: Statutory Reserves: Amalgamation Adjustment A/c Dr. (Total Amount of Statutory Reserves) To Particular Statutory Reserve A/c (Individually)			
	Step 5: Discharge of Debentures: Debentures in Transferor Company A/c Dr. To Debentures in Transferee Company A/c To Securities Premium A/c To Bank A/c			

	To Equity Share Capital A/c **To Pref. Share Capital A/c**			
	Step 6: Liquidation Expenses (Paid and Borne by Transferee Company: **Goodwill A/c Dr.** **To Bank A/c** **Step 7: Formation Expenses (In Case of a New Company)** **Preliminary Expenses A/c Dr.** **To Bank A/c**			
	[Note: If both goodwill A/c and capital reserve appear in the books of transferee company, then goodwill A/c should be set off against the capital reserve A/c. The entry will be: **Capital Reserve A/c Dr.** **To Goodwill A/c]**			

Illustration 4: The balance sheet of ABC Ltd. as at 31 March 2011 is as follows:

Liabilities	**Rs.**	**Assets**	**Rs.**
Equity Share Capital	5,00,000	Building	2,00,000
10% Preference Share Capital	1,50,000	Plant & Machinery	3,00,000
12% Debentures	1,00,000	Furniture	70,000
Reserve Fund	40,000	Investment (MV 80,000)	90,000
Securities Premium	30,000	Stock	75,000
Profit & Loss A/c	10,000	Debtors	2,80,000
Workmen Compensation Fund	45,000	Bills Receivable	25,000
Bills Payable	25,000	Cash in Hand	15,000
Creditors	1,70,000	Cash at Bank	85,000
Provident Fund	80,000	Goodwill	20,000
Provision for Tax	20,000	Preliminary Expenses	10,000

XYZ Ltd. intends to take over the business on the following terms and valuation:

(i) Building at Rs.1,70,000; plant & machinery at Rs. 2,50,000; furniture at Rs. 15,000; stock at Rs. 1,00,000; debtors subject to a provision of 10% for doubtful debts; goodwill found to be nil

(ii) There was a liability of Rs. 15,000 against workmen compensation fund.

(iii) Actual tax liability is Rs. 25,000

(iv) Realization expenses estimated at Rs.10,000 to be borne by XYZ Ltd.

(v) Preference shareholders are to be paid in cash

(vi) Balance to be paid in equity shares of XYZ Ltd. of Rs. 10 shares

Model: Purchase consideration—Net assets method

Solution:

Computation of Purchase Consideration:

Step 1: Assets Taken Over (At Agreed Value)	Rs	Rs.
(i) Building (At Agreed Value) (ii) Plant & Machinery (At Agreed Value) (iii) Furniture (At Agreed Value) (iv) Stock (At Agreed Value) (v) Debtors: Rs. 2,80,000 Less: Provision @ 10% Rs.28,000	1,70,000 2,50,000 15,000 1,00,000 2,52,000	
(vi) Investments (At Market Value) (vii) Bills Receivable (As in B/S) (viii) Cash in Hand (As in B/S) (ix) Cash at Bank (As in B/S) Step 2: Add (i) to (ix)	80,000 25,000 15,000 85,000	9992000
Step 3: Liabilities Taken Over: (i) Creditors (As Shown in B/S) (ii) Bills Payable (As Shown in B/S) (iii) Provident Fund (As Shown in B/S) (iv) Workmen Compensation Fund (Agreed Value) (v) Provision for Tax (Agreed Value) (vi) 12% Debentures	1,70,000 25,000 80,000 15,0000 25,000 1,00,000	
Step 4: Add: Step 3 (i) to (vi) Step 5: Purchase Consideration (Step 2 – Step 4) =		415000 577000

Payment of Purchase Consideration (As per Directions Given in the Problem):
Rs.

For Preference Share holders in Cash: 1,50,000

Balance in 42,700 Equity Shares (of Rs.10 Each)

4,27,000 (Rs. 5,77,000 – Rs. 1,50,000 = 4,27,000)

Total **5,77,000**

9.6 Need for Amalgamation

To obtain financial resources

- Take out the competition.
- Tax breaks
- Large-scale operation economies
- Increase the value of shareholders
- Diversification can help to reduce risk.
- Managerial efficiency

- To achieve financial success and growth

Summary

- Amalgamation, as the name implies, is the joining of two businesses to conduct business for a common purpose.
- The process by which one powerful company takes control of a weaker company is known as absorption.
- Amalgamation occurs when two or more companies engage in the same line of business or have some operational synergy.
- Companies may also merge to diversify their activities or expand their service offerings.
- The transferor company is the one that is amalgamated into another company, whereas the transferee company is the one that is amalgamated into the transferor company.

Keywords

- Amalgamation
- Purchase Consideration
- Realization account
- Transferor and Transferee Company
- Lump sum method

Review Questions

1 What exactly is amalgamation? Describe the primary goal of the company merger.

2. What is the accounting treatment of amalgamation in Transferor Company's books?

3. Describe the buying process. What are the methods used to calculate purchase consideration?

4. Describe the key features of the pooling of interests method.

5. What is the accounting treatment of amalgamation in Transferee Company's books for amalgamation in the nature of merging?

Self Assessment

1. Absorption occurs when two or more companies merge to form a new company.

A. True
B. False

2. When calculating purchase consideration using the 'net asset method,' all assets, including fictitious assets, should be considered.

A. True
B. False

3. There is one liquidation and one formation during external reconstruction.

A. True
B. False

4. There are two or more liquidations and one formation in case of amalgamation of company .

A. True
B. False

5. Accounting standard 14 does not differentiate between amalgamation and absorption.

A. True
B. False

6. Absorption occurs when an existing company acquires one or more other existing companies.

A. True

B. False

7. Payments to creditors do not form part of the Purchase of Consideration upon amalgamation.

A. True

B. False

8. The nature of external reconstruction is similar to that of amalgamation in terms of purchase.

A. True
B. False

9. Under the net assets method, accumulated profits should not be included in liabilities.

A. True
B. False

10. AS 13 governs corporate mergers and acquisitions.

A. True

B. False

Answer for Self Assessment

1.	B	2.	B	3.	A	4.	A	5.	A
6.	A	7.	A	8.	A	9.	A	10.	B

Review Questions

1 What exactly is a Cash Flow Statement? Describe the main goals of the cash flow statement.

2.Specify cash in accordance with AS-3 (revised). When preparing a cash flow statement, how are the various activities classified according to AS-3 revised?

3. Describe three operational activities.

4.Explain two examples of investment activities.

5. The comparative balance sheets of Anjali Ltd. as of March 31, 2007 are presented below.

Details	2007 Amount (Rs)	2006 Amount (Rs)
Cash	40000	57000
Account Receivables	77000	64000
Inventory	132000	140000
Prepaid expenses	12140	16540
Land	125000	150000
Equipment	200000	175000
Accumulated Depreciation (Equipment)	(60000)	(42000)
Building	250000	250000
Accumulated Depreciation (Building)	(75000)	(50000)
	701140	760540
Account payables	33000	45000
Bond payables	235000	265000
Equity share capital (Rs 10 per share)	280000	250000
Retained earnings	153140	200540
	701140	760540

Further Readings

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Unit 10:Amalgamation II

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Difference between amalgamation in the nature of merger and in the nature of purchase
- Understand accounting treatment in the books of transferor company
- Understand Accounting Treatment in the Books of Transferee (Purchasing) Company

Introduction

Amalgamation means an amalgamation pursuant to the provisions of the Companies Act 2013 or any other statute which may be applicable to companies.

The accounting for amalgamation depends on whether amalgamation is in the nature of merger or in the nature of purchase.

10.1 Introduction and types of Amalgamation

The Standard AS-14 classifies amalgamation into two categories:

1. Amalgamation in the nature of merger

2. Amalgamation in the nature of purchase

In an amalgamation, two or more companies are combined into one by merger or by one taking over the other.

Therefore, the term 'amalgamation' contemplates two kinds of activities:

(i) two or more companies join to form a new company or

(ii) absorption and blending of one by the other.

Thus, amalgamation include absorption.

The purpose of companies joining together is to secure various advantages such as economies of large scale production, avoiding competition, increasing efficiency, expansion etc.

The companies going into liquidation or merged companies are called vendor companies or transferor companies.

The new company which is formed to take over the liquidated companies or the company with which the transferor company is merged is called transferee or vendee.

In the case of amalgamation the assets and liabilities of transferor company(s) are amalgamated and the transferee company becomes vested with all such assets and liabilities.

Wherever 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, there is external reconstruction.

Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS (Accounting Standard) 14, Accounting for Amalgamations.

Difference

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 reorganise the financial structure of the company.

10.2 Amalgamation in the Nature of Purchase

When the assets and liabilities of the company are acquired by another and purchase consideration is paid by the transferee company.

When it comes to the method of accounting, if the amalgamation affected is in the nature of merger, then pooling of interest method is followed, whereas if the amalgamation is in the nature of the purchase, in that case, purchase method is followed.

The amalgamation is in the nature of purchase, if any one or more of the conditions stipulated for themerger are not satisfied.Hence, in the amalgamation in the nature of purchase:

1. Selling company's business will not be carried on in future

2. Shareholders holding 90% of the transferor company will not become shareholders of the transfereecompany

3. All the assets and liabilities of the selling company will not be taken over by the transferee company

4. Consideration payable to shareholders of transferor company may be in the form of shares or cash or inany other agreed form

5. Assets and liabilities taken over by the transferee company may be shown at values other than bookvalues at the discretion of the transferee company

Note: Transferor company is the "selling company" and transferee company is the "purchasing company".The Accounting Standard, for the purpose of accounting, recommends the "pooling of interests method"in the case of "amalgamation in the nature of merger" and the "purchase method" for "amalgamation in thenature of purchase". These methods will be discussed in detail later.

Difference

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.

e) 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.

10.3 Accounting Treatment in the Books of Transferor (Selling or Vendor) Company

Important note:

The accounting procedure is SAME for all types of amalgamation, whether it is in the nature of "merger" or "purchase", in the books of the transferor (vendor) company.

Date	Particulars	Lf	Dr	Cr
	Step 1: Transfer of Assets: Realization A/c Dr. To Assets (Individually) Account [Important Hints for transfer of assets: (i) All assets, whether taken over or not must be transferred to realization a/c at book value.			
	(ii) Provisions should not be deducted, but to be shown separately by crediting realization a/c. (iii) Agreed values should be ignored. (iv) Each and every asset has to be transferred individually. (v) Fictitious assets are to be ignored. (They should not be transferred to realization a/c)			
	(vi) When amalgamation is in the nature of purchase, cash in hand and cash at bank are to be transferred to realization a/c if they are taken over by the transferee company. When amalgamation is in the nature of merger, these accounts MUST be transferred to realization a/c.			
	(vii) All intangible accounts such as goodwill, patent copyrights are to be transferred to realization a/c. In case, they are mentioned as worthless, then they have			

	to be transferred to shareholders A/c as "loss".]			
	Step 2: Transfer of Liabilities: Liabilities (Individually) A/c Dr. To Realization A/c [Important Hints for Transfer of Liabilities: (i) Liabilities not taken over and liabilities to be settled by immediate payment are not to be transferred to realization a/c. (ii) Liabilities should be transferred as their respective book values.			
	(iii) All the items shown under the heads "Secured Loans" and "Unsecured Loans" are to be transferred whether they are taken over or not by the transferee (purchasing) company. This also includes "Debentures", irrespective of the method of calculating purchase consideration			
	(iv) Any amount in the nature of reserve should not be transferred to realization a/c. Example: Accumulated profits (P&L A/c credit balance), sinking fund, dividend equalization fund, debenture redemption fund, i.e., all funds in the nature of profits.			
	(v) Funds which are not reserves are to be transferred to realization A/c. Example: Pension fund, PF, superannuation fund. (vi) Funds which are partly profit and partly liability—only liability part is to be transferred to realization A/c and the other part is to be transferred to shareholders A/c.			
	Step 3: Purchase Consideration—DUE: (Purchasing) Transferee Co's A/c Dr. To Realization A/c Step 4: Realization Expenses : (a) If (a) If Liquidation Expenses Are Paid and Borne by the Transferor Company (Selling/Vendor) Realization A/c Dr. To Bank A/c			

	(b) If the Transferor Pays and Later Gets Reimbursed by Transferee Company: (i) Transferee Company's A/c Dr. To Bank A/c (ii) Bank A/c Dr. To Transferee Company's A/c Note: At times, actual expenses paid and the reimbursement amount may vary. In such cases, the difference will be adjusted with realization A/c.			
	(c) If Liquidation Expenses Are Paid and Borne by the Purchasing (Transferee) Company, then No Need to Enter in the Books of the Vendor (Transferor) Company. (However, the Liquidation Expenses Reimbursable Are Not at All to Be Included in the Purchase Consideration According to AS-14)			
	Step 5: Realization of Assets Not Taken Over by the Purchasing Company (Recorded or Not Recorded): Bank A/c [Amount Realized] Dr To Realization A/c			
	Step 6: Payment of Liabilities Not Taken Over: Realization A/c Dr. To Bank A/c [Note: In the settlement of liability, if there is premium, realization A/c is to be debited or credited in case of discount.]			
	Step 7: Discharge of Preference Share Capital: (a) When Payable at Premium: Preference Share Capital A/c [Face Value] Dr. Realization A/c (Premium) Dr. To Preference Shareholders A/c [Total]			
	(b) When Payable at Discount: Preference Share Capital A/c (Face Value) Dr. To Preference Shareholders A/c (Net Amount Payable) To Realization A/c (Amount of Discount)			
	(c) When Payable at Par: Preference Share Capital A/c (Face Value) Dr. To Preference Shareholders A/c (Face Value) [Note: At times, on amalgamation, may be paid as premium			

	or discount. In such cases, they have to be adjusted in realization A/c first and only then their profit/loss is to be determined.]			
	Step 8: Profit/Loss on Realization: (a) When There Is Profit on Realization: Realization A/c [With Profit Amount] Dr. To Equity Shareholders A/c (b) When There is Loss on Realization: Equity Shareholders A/c (With Loss Amount) Dr. To Realization A/c			
	Step 9: On Receipt of Purchase Consideration: Bank A/c (In the Form of Cash) Dr. Preference Shares in Transferee Company's A/c (In the Form of Equity Shares) Dr. Equity Shares in Transferee Company's A/c Dr. (In the Form of Equity Share) To Transferee Company's A/c (Total) [Purchasing Company's A/c Will Be Closed with This Entry]			
	Step 10: Transfer of Equity Share Capital, Accumulated Profits & Reserves: Equity Shares Capital A/c Dr. Capital/Revenue A/c Dr. General Reserve A/c Dr. Any Other Reserve A/c Dr. Profit & Loss A/c Dr. To Equity Shareholders A/c			
	Step 11: Transfer of Accumulated Losses and Fictitious Assets: Equity Shareholders A/c Dr. To Preliminary Expenses A/c To Underwriting Commission A/c To Discount on Issue of Shares/Debentures A/c To Profit & Loss A/c			
	Step 12: Final Settlement of Claims to Preference Shareholders. Preference Shareholders A/c (Amount Due) Dr. To Bank A/c (Cash Paid) To Preference Share in Transferee Company A/c (Paid in the Form of Pref. Shares)			
	Step 13: Final Payment to Equity Shareholders: Equity Shareholders A/c (Amount Due) Dr.			

	To Bank A/c (Cash Paid) To Equity Share in Transferee Company A/c (Paid in the Form of Equity Shares) [Note: Vendor company's account will get closed after payment is made to equity shareholders.]				

Illustrations 1: Balance sheets of X Ltd and Y Ltd (in Rs 000's) were as follows on 31 Mar 2022:

	X ltd	Y ltd
Assets:	-	350
Goodwill	1,000	—
Patents	3,000	—
Land & Buildings	7,750	—
Plant & Machinery	—	200
Motor Vehicles	—	125
Furniture	0,575	—
Investments	1,750	1,195
Stocks	400	310
Debtors	225	85
Cash at Bank		
Liabilities:	2,500	—
Share Capital: 25,000 Pref. Shares of Rs. 100 Each	7,500	—
7,50,000 Equity Shares of Rs. 10 Each	—	2,000
2,00,000 Equity Shares of Rs.10 Each	4,000	—
General Reserve	450	160
Profit and Loss A/c	250	105
Creditors		

A new company Z Ltd. was formed to acquire the assets and liabilities of X Ltd. and Y Ltd. The terms of acquisition of business were as follows:

(i) Z Ltd. to have an authorized capital of Rs.1,75,00,000 divided into 25,000 12% preference shares of Rs. 100 each and 15,00,000 lakh equity shares of Rs. 10 each

(ii) Business of X Ltd. valued at Rs. 1,50,00,000; settlement being Rs. 30,00,000 cash and balance by issue of fully paid equity shares of Rs. 12 each.

(iii) Business of Y Ltd. valued at Rs. 24,00,000 to be settled by issue of fully paid equity shares of Rs.12 each

(iv) Preference shares of X Ltd. were redeemed

You are required to make journal entries in the books of X Ltd. and Y Ltd. to close their books of account and also show the necessary ledger Accounts

Solution:

Books of X Ltd.

Journal

Date	Particulars	Lf	Dr	Cr
	Step 1: For Assets Taken Over by Z Ltd.			
	Realization A/c Dr.		14,700	
	To Patents			1,000
	To Land & Buildings			3,000
	To Plant & Machinery			7,750
	To Investment			575
	To Stock			1,750
	To Debtors			400
	To Bank			225
	(Transfer of All Assets Taken Over by Z Ltd.)			
	Step 2: For Liabilities Taken Over:			
	Creditors A/c Dr.		**250**	
	To Realization A/c			**250**
	(Transfer of Creditors to Realization A/c)			
	Purchase Consideration Due (Given)			
	Z Ltd. A/c Dr.		**15,000**	
	To Realization A/c			**15,000**
	(Purchase Consideration Due from Z Ltd.)			
	Step 4: Profit on Realization (Ref: Realization A/c—Ledger)			
	Realization A/c Dr.		**550**	
	To Equity Shareholders A/c			**550**
	(Profit on Realization Transferred to Shareholders A/c)			
	Step 5: On Receipt of Purchase Consideration:			
	Equity Shares in Z Ltd. Dr.		**12,000**	
	Bank A/c Dr.		**3,000**	
	To Z Ltd. A/c			**15,000**
	(Purchase Consideration Received in Shares and Cash)			
	Step 6: Amount Due to Preference Shareholders:			
	Preference Share Capital A/c Dr.		**2,500**	
	To Preference Shareholders A/c			**2,500**
	(Amount Due to Preference Shareholders)			
	Step 7: Settlement of Claim to Pref. Shareholders			
	Preference Shareholders A/c Dr.		**2,500**	
	To Bank A/c			**2,500**
	(Payment Made to Pref. Shareholders			
	Step 8: Amount Due to Equity shareholders			

	Equity Share Capital A/c	**Dr.**	**7,500**	
	General Reserve A/c	**Dr.**	**4,000**	
	Profit & Loss A/c	**Dr.**	**450**	
	To Equity Shareholders A/c			**11,950**
	(Amount Due to Equity Shareholders)			
	Step 9: Settlement of Claims to Equity Shareholders:			
	Equity Shareholders A/c	**Dr.**	**12,500**	
	To Equity Shares in Z Ltd.			**12,000**
	To Bank A/c			**500**
	(Payment Made to Equity Shareholders in Cash & Shares)			

1. Realization A/c

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
	To Sundry Assets:	1,000		By sundry creditor	250
	Patents	3,000		By Z Ltd.	15,000
	Land & Buildings Plant & Machinery Investments	7,750			15250
		575			
	Stock	1,750			
	Debtors	400			
	Bank	225			
	*1To Equity Shareholders A/c	15250			
	(Profit Bal. Fig)				

2. Preference Shareholders A/c

Particulars	Rs.	Particulars	Rs.
To Bank a/c	2500	By pref. shareholder a/c	2500

3. Equity Shareholders A/c

Particulars	Rs.	Particulars	Rs.
To Equity Shares in Z Ltd.	12,000	By Equity Share Capital A/c	7,500
To Bank A/c	500	By General Reserve	4,000
		By Profit and Loss A/c	450
		By Realization A/c	550

4. Equity Shares in Z Ltd.

Particulars	**Rs.**	**Particulars**	**Rs.**
To Z Ltd.	12,000	By Equity Shareholders A/c	12,000

5. Z Ltd. A/c

Particulars	**Rs.**	**Particulars**	**Rs.**
To Realization A/c	15,000	By Bank A/c By Share in Z Ltd	3,000 12,000

6. Bank A/c

Particulars	**Rs.**	**Particulars**	**Rs.**
To Z Ltd.	3,000	By Equity Shareholders A/c By Pref. Shareholders A/c	500 2500

Books of Y Ltd.

Journal

Date	Particulars		Lf	Dr	Cr
	Step 1: Assets Taken Over:				
	Realization A/c	Dr.		2,265	
	To Goodwill				350
	To Motor Vehicles				200
	To Furniture				125
	To Stocks				1,195
	To Debtors				310
	To Bank				85
	(Transfer of All Assets Taken Over by Z Ltd.)				
	Step 2: Liabilities Taken Over:				
	Sundry Creditors A/c	Dr.		105	
	To Realization A/c				105
	(Transfer of Liabilities Taken Over)				
	Step 3: Purchase Consideration Due (Given):				
	Z Ltd. A/c	Dr.		2,400	
	To Realization A/c				2400
	(Purchase Consideration Due)				

	Step 4: Realization Profit (Ref : Realization A/c): Realization A/c Dr. 240 To Equity Shareholders A/c 240 +'(Realization Profit Transferred to Equity Shareholders A/c)
	Step 5: Amount Due to Equity Shareholders: Equity Shares Capital A/c Dr. 2000 Profit and Loss A/c Dr. 160 To Equity Shareholders A/c 2160 (Amount Due to Equity Shareholders)
	Step 6: On Receipt of Purchase Consideration: Equity Shares in Z Ltd. Dr. 2,400 To Z Ltd. A/c 2400 (Purchase Consideration Received)
	Step 7: Settlements to Equity Shareholders: Equity Shareholders A/c Dr. 2,400 To Shares in Z Ltd. 2400 (Amount Paid to Equity Shareholders in the Form of Shares)

1. Realization A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
	To Sundry Assets:	350		By sundry creditor	105
	Goodwill	200		By Z Ltd.	2400
	Motor vehicle	125			**2505**
	Furniture	1195			
	Stocks	310			
	Debtors	85			
	Bank	240			
	+'To Equity Shareholders A/c	**2505**			
	(Profit Bal. Fig)				

2. Equity Shareholders A/c

Particulars	Rs.	Particulars	Rs.
To Equity Shares in Z Ltd.	2400	By Equity Share Capital A/c	2000
		By Profit and Loss A/c	160
		By Realization A/c	240

3. Equity Shares in Z Ltd.

Particulars	Rs.	Particulars	Rs.
To Z Ltd.	2400	By Equity Shareholders A/c	2400

4. Z Ltd. A/c

Particulars	Rs.	Particulars	Rs.
To Realization A/c	2400	By equity Share in Z Ltd	2400

10.4 Accounting Treatment in the Books of Transferee Company

Accounting treatment in the books of purchasing company is based on the nature of amalgamation. Accounting Standard AS-14 stipulates two methods of accounting for amalgamation:

1. Pooling of interest methods

2. Purchase method

When the amalgamation is in the nature of merger, the transferee company has to apply "pooling of interests method". When the amalgamation is in the nature of purchase, the transferee company has to apply "purchase method"

Pooling of Interests Method

Pooling of assets, liabilities, capital, reserves and business of both companies takes place in this method:

1. The assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (i.e., book values). That means no adjustment is made in the book values of assets and liabilities of the transferor company. Further, fi ctitious assets are not assets and hence should not be incorporated in the books of transferee company.

2. The effects on the fi nancial statements of any changes in accounting policies are to be reported as per AS-5.

3. The purchase consideration under this method is to be valued at par value of shares issued.

4. The balance in the profi t and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve.

5. The difference between the amount recorded as share capital issued + additional consideration in form of cash or other assets and the amount of share capital is to be adjusted in reserves in fi nancial statements of the transferee company.

The Expert Advisory Committee of ICAI Recommends:

(a) The difference between the issued share capital of the transferee company and share capital of transferor company should be treated as CAPITAL RESERVE.

(b) Reserve created on amalgamation is not available for dividend and/or bonus shares issued.

Journal Entries in the Books of Transferee Company

(Pooling of Interest Method)

Date	Particulars	Lf	Dr.	Cr.

	Step 1: Purchase of Business: Business Purchase A/c Dr. (With the Amount of Purchase Consideration.) To Liquidators of Transferor Company			
	Step 2: Take Over of the Assets, Liabilities and Reserves of the Transferor Company: Sundry Assets A/c (Individually) Dr. To Sundry Liabilities A/c (Individually) To Profit and Loss A/c To Reserves A/c (Individually) To Business Purchase A/c [Note: All assets and liabilities are to be recorded at their book values separately. But at times, book value gets adjusted according to the accounting policy of purchasing company.]			
	Step 3: Settlement of Purchase Consideration: (i) When Shares Are Issued at Par: Liquidators of Transferor Company A/c Dr. To Equity Share Capital A/c To Preference Share Capital. A/c To Bank A/c (ii) When Shares Are Issued at Premium: Liquidators of Transferor Company A/c Dr. To Equity Share Capital A/c To Preference Share Capital A/c To Securities Premium A/c To Bank A/c			
	Step 3: Settlement of Purchase Consideration: (iii) When Shares Are Issued at Discount: Liquidators of Transferor Company A/c Dr. Discount on Issue of Shares A/c Dr. To Equity Share Capital A/c To Preference Share Capital A/c To Bank A/c			
	Step 4: Discharge of Liabilities: (i) When Debentures Are Issued at Par: Debentures of Transferor Company A/c Dr. To Debentures (of Transferee Company) A/c			

	(ii) When Debentures Are Issued at Premium: Debentures of Transferor Company A/c Dr. To Debentures (of Transferee Company) A/c To Securities Premium A/c			
	Step 4: Discharge of Liabilities: (iii) When Debentures Are Issued as Discount: Debentures of Transferor Company A/c Dr. Discount on Issue of Debentures A/c Dr. To Debentures (of Transferor Company) A/c			
	Step 5: Liquidation Expenses: (i) Liquidation Expenses A/c Dr. To Bank A/c (ii) General Reserve/P&L A/c Dr. To Liquidation Expenses A/c			
	Step 6: Formation Expenses: Preliminary Expenses A/c Dr. To Bank A/c [Note: At times, preliminary expenses are not written off against general reserve or P&L A/c. In such cases, it will be shown on the assets side of B/S under "Miscellaneous Expenditure".]			

Purchase Method

Accounting for amalgamation: When amalgamation is in nature of purchase, "purchase method" will have to be applied, in accordance with AS-14.

Accounting Entries in the Books of Transferee Company

(Purchase Method)

Date	Particulars	Lf	Dr	Cr
	Step 1: Business Purchase: (Purchase of Business) Business Purchase A/c Dr. To Liquidators of Transferor Company A/c **Step 2:** Taken Over of Assets of Liabilities: All Assets A/c (Individually) at Agreed Values Dr. To Liabilities A/c (Individually) at Agreed Values To Debentures in Vendor's Company A/c … To Business Purchase A/c			
	[Important Hints & Notes: Case 1: If total amount of credit accounts is greater than the total amount of debit accounts, the difference is to be treated as a capital loss and is to be debited to goodwill A/c. Then entry will be:			

	Goodwill A/c (Balancing Figure) Dr. **Assets A/c (Individually) Dr.** **To Liabilities A/c (Individually)** **To Business Purchase A/c**			
	Case 2: On the other hand, if total amount of debit accounts is greater than the total amount of credit accounts, then the difference is to be treated as a capital profit and is to be credited **to capital reserve A/c. Then entry will be:** **Assets A/c (Individually) Dr.** **(Excluding Goodwill A/c)** **To Liabilities A/c (Individually)** **To Business Purchase A/c** **To Capital Reserve A/c (Balancing Figure)**			
	Case 3: If there are both goodwill & capital reserve, then only net amount has to be shown in the B/S]. **Step 3: Payment of Purchase Consideration:** **(i) When Securities Are Issued at Par:** **Liquidators of Transferor Company A/c Dr.** **To Bank A/c** **To Equity Share Capital A/c** **To Preference Share Capital A/c** **To Debentures A/c**			
	(ii) When Securities Are Issued at Premium: **Liquidators of Transferor Company A/c Dr.** **To Bank A/c** **To Equity Share Capital A/c ...** **To Preference Share Capital A/c ...** **To Debentures A/c ...** **To Securities Premium A/c**			
	(iii) When Securities Are Issued at Discount: **Liquidator of Transferor Company A/c Dr.** **Discount on Issue of Shares A/c Dr** **Discount on Issue of Debentures A/c Dr.** **To Bank A/c** **To Equity Share Capital A/c ...** **To Preference Share Capital A/c ...** **To Debentures A/c**			
	Step 4: Statutory Reserves: **Amalgamation Adjustment A/c Dr.** **(Total Amount of Statutory Reserves)**			

	To Particular Statutory Reserve A/c (Individually)			
	Step 5: Discharge of Debentures: **Debentures in Transferor Company A/c Dr.** **To Debentures in Transferee Company A/c** **To Securities Premium A/c** **To Bank A/c** **To Equity Share Capital A/c** **To Pref. Share Capital A/c**			
	Step 6: Liquidation Expenses (Paid and Borne by Transferee Company: **Goodwill A/c Dr.** **To Bank A/c** **Step 7: Formation Expenses (In Case of a New Company)** **Preliminary Expenses A/c Dr.** **To Bank A/c**			
	[Note: If both goodwill A/c and capital reserve appear in the books of transferee company, then goodwill A/c should be set off against the capital reserve A/c. The entry will be: **Capital Reserve A/c Dr.** **To Goodwill A/c]**			

Illustration 4: The balance sheet of ABC Ltd. as at 31 March 2011 is as follows:

Liabilities	Rs.	Assets	Rs.
Equity Share Capital	5,00,000	Building	2,00,000
10% Preference Share Capital	1,50,000	Plant & Machinery	3,00,000
12% Debentures	1,00,000	Furniture	70,000
Reserve Fund	40,000	Investment (MV 80,000)	90,000
Securities Premium	30,000	Stock	75,000
Profit & Loss A/c	10,000	Debtors	2,80,000
Workmen Compensation Fund	45,000	Bills Receivable	25,000
Bills Payable	25,000	Cash in Hand	15,000
Creditors	1,70,000	Cash at Bank	85,000
Provident Fund	80,000	Goodwill	20,000
Provision for Tax	20,000	Preliminary Expenses	10,000

XYZ Ltd. intends to take over the business on the following terms and valuation:

(i) Building at Rs.1,70,000; plant & machinery at Rs. 2,50,000; furniture at Rs. 15,000; stock at Rs. 1,00,000; debtors subject to a provision of 10% for doubtful debts; goodwill found to be nil

(ii) There was a liability of Rs. 15,000 against workmen compensation fund.

(iii) Actual tax liability is Rs. 25,000

(iv) Realization expenses estimated at Rs.10,000 to be borne by XYZ Ltd.

(v) Preference shareholders are to be paid in cash

(vi) Balance to be paid in equity shares of XYZ Ltd. of Rs. 10 shares

Model: Purchase consideration—Net assets method

Solution:

Computation of Purchase Consideration:

Step 1: Assets Taken Over (At Agreed Value)	Rs	Rs.
(i) Building (At Agreed Value) (ii) Plant & Machinery (At Agreed Value) (iii) Furniture (At Agreed Value) (iv) Stock (At Agreed Value) (v) Debtors: Rs. 2,80,000 Less: Provision @ 10% Rs.28,000	1,70,000 2,50,000 15,000 1,00,000 2,52,000	
(vi) Investments (At Market Value) (vii) Bills Receivable (As in B/S) (viii) Cash in Hand (As in B/S) (ix) Cash at Bank (As in B/S) Step 2: Add (i) to (ix)	80,000 25,000 15,000 85,000	9992000
Step 3: Liabilities Taken Over: (i) Creditors (As Shown in B/S) (ii) Bills Payable (As Shown in B/S) (iii) Provident Fund (As Shown in B/S) (iv) Workmen Compensation Fund (Agreed Value) (v) Provision for Tax (Agreed Value) (vi) 12% Debentures	1,70,000 25,000 80,000 15,0000 25,000 1,00,000	
Step 4: Add: Step 3 (i) to (vi) Step 5: Purchase Consideration (Step 2 – Step 4) =		415000 577000

Payment of Purchase Consideration (As per Directions Given in the Problem):
Rs.

For Preference Share holders in Cash: 1,50,000

Balance in 42,700 Equity Shares (of Rs.10 Each)

4,27,000 (Rs. 5,77,000 – Rs. 1,50,000 = 4,27,000)

Total 5,77,000

10.5 Need for Amalgamation

To obtain financial resources

- Take out the competition.
- Tax breaks
- Large-scale operation economies
- Increase the value of shareholders
- Diversification can help to reduce risk.
- Managerial efficiency
- To achieve financial success and growth

Summary

Amalgamation: When two or more existing companies combine to form a new company, it is amalgamation.

Absorption: When one existing company takes over the business of one or more existing companies, it is absorption.

External reconstruction: When one existing company is wound up and a new company is floated with the same shareholders, it is external reconstruction. Legally, amalgamation includes absorption. AS-14 deals with accounting for amalgamation. Reorganization of a company without winding up (liquidating) the company is internal reconstruction. On the other hand, if it involves the liquidation of the existing company, it is external reconstruction.

Types of amalgamation: (i) Amalgamation in the nature of merger and (ii) Amalgamation in the nature of purchase. Purchase consideration: It refers to the total amount payable to the shareholders of transferor company.

Methods of computation of purchase consideration:

(i) Lump sum method (ii) Net payment method (iii) Net assets method and (iv) Intrinsic value method. Each method is explained with a sufficient number of illustrations (Ref: The text). Items that are to be treated as liabilities, trade liabilities, provisions, accumulated profits and accumulated losses are explained clearly. (Ref: the text for detail)

Keywords

- Amalgamation
- Purchase Consideration
- Realization account
- Transferor and Transferee Company
- Lump sum method

Review Questions

1 What exactly is amalgamation? Describe the primary goal of the company merger.

2. What is the accounting treatment of amalgamation in Transferor Company's books?

3. Describe the buying process. What are the methods used to calculate purchase consideration?

4. Describe the key features of the pooling of interests method.

5. What is the accounting treatment of amalgamation in Transferee Company's books for amalgamation in the nature of merging?

Self Assessment

1. In absorption, no new company is formed.

A. True
B. False

2. A new company is floated with new shareholdersin “external reconstruction”.

A. True
B. False

3. There is one liquidation and one formation during external reconstruction.

A. True
B. False

4. As per Sections 390 & 396 (A) of the CompaniesAct, any scheme of amalgamation requires theapproval of a court.

A. True
B. False

5. As per AS-14, amalgamation differs from absorption

A. True
B. False

6. Internal reconstruction requires the winding upof an existing company.

A. True
B. False

7. External reconstruction is more or less sameas that of “amalgamation in the nature ofpurchase.

A. True
B. False

8. In the case of amalgamation in the nature ofmerger, all the assets and liabilities of the sellingcompany will become the assets and liabilities ofthe purchasing company.

A. True
B. False

9. Adjustment has to be made in the book valuesof the assets and liabilities of the transferorcompany when they are transferred to thefinancial statements of the purchasing company,when amalgamation is in the nature of merger.

A. True
B. False

10. The aggregate of agreed payments represents the“net payment method”.

A. True
B. False

Answer for Self Assessment

1.	A	2.	B	3.	A	4.	B	5.	B
6.	A	7.	A	8.	B	9.	B	10.	A

Review Questions

1. Name the two types of amalgamation.
2. Mention the important features in amalgamation in the nature of merger.
3. What are the salient features in amalgamation in the nature of purchase?
4. Mention the methods of computing purchase consideration.
5. What are the types of amalgamation? Elucidate the salient features of each such type. How do they differ from each other?
6. What are the methods of accounting for amalgamations? Discuss the salient features of each method. How do they differ from each other?
7. On 31 March 2022, the balance sheet of AX Ltd stood as follows

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital:	7,50,000	Plant & Machinery	8,05,000
75,000 Equity Shares of Rs. 10 Fully Paid	75,000		97,200
		Furniture & Fixtures	
	3,12,750		3,52,750
Securities Premium	92,650	Stock	99,220
	1,80,370	Debtors	56,600
General Reserve			
		Cash at Bank	
Profit & Loss A/c			
Creditors			

On this date AX Ltd. took over the business of BY Ltd. for Rs.3,30,000 payable in the form of its fully paid equity shares of Rs. 10 each at par. Shareholders of BY Ltd. get 110 shares of AX Ltd. for every 100 shares held in BY Ltd. The scheme of amalgamation also provided that 1,500 12% debentures of BY Ltd. would be converted into equal number of 14% debentures of AX Ltd. of Rs. 100 each. The balance sheet of BY Ltd. on the date of amalgamation was as follows:

On 31 March 2022, the balance sheet of AX Ltd stood as follows:

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital:	3,00,000	Machinery	2,75,000
30,000 Equity Shares of Rs10 Each	6,500	Furniture	67,600

Fully	4,850	Stock	1,57,900
Paid	37,675	Debtors	64,650
CapitalReserve	12,065	Cash at Bank	37,180
Foreign Projects Reserve	1,50,000		
General Reserve	91,240		
Profit & Loss A/c			
1,500 12% Debentures of Rs100 Each			
Creditors			

You are required to pass journal entries in the books of AX Ltd. assuming that the amalgamation is in the nature of merger.

Model: Journal entries in the books of transferee company—amalgamation in the nature of merger.

Further Readings

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Unit 11:Internal Reconstruction

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Understand nature of internal reconstruction
- Understand the need for internal reconstruction
- Understand the alteration of share capital
- Understand Reduction of share capital as method of Internal Reconstruction
- Elaborate accounting treatment related to internal reconstruction

Introduction

Nowadays, companies have been constantly engaged in restructuring their financial structure to effect economy and enhance profitability. Of the many devices adopted by them, reconstruction is one such device to achieve the desired goal. During such reorganization process, if the task is accomplished without liquidating the company, it is referred to as "internal reconstruction". It is primarily concerned with creating a robust financial position of a company. It brings forth a true, fair and real value of assets through which the true financial position of a company can be projected. In this chapter, the need and various methods employed for internal reconstruction are discussed in detail.

11.1 Need for Internal Reconstruction

1. *True and fair view of financial position:* A company may be incurring losses for several years. In suchcases, the financial position cannot reflect a true and fair view. Hence, it necessitates reorganization inorder to disclose the actual financial position of an enterprise.

2. *Value of assets:* On a careful analysis, it may reveal that such continuous loss-making companiesconsist either overvalued tangible assets or insignificant intangible assets. To get rid of these unrealvalues of assets, they should be updated to their real values by way of reconstruction.

3. *External liabilities:* External liabilities include loan, payment of preference dividends, debentures, etc. These cannot be discharged on stipulated and specified time. These have to be reduced to a great extent to maximize profitability through reorganization.

4. *Share capital*: The capital figure (i.e., the value of net assets) is not reliable as it tends to show a higher figure than the real figure due to various factors such as overvalued tangible assets, idle and

valueless intangible assets and fictitious assets, and outstanding liabilities not discharged on maturity date. Because of this, the share capital of such loss-incurring companies will not reflect the real and fair value of the net assets of the company. To set right this sort of over capitalization, reconstruction is of vital importance.

5. Remedial measure: If proper reorganization does not take place, it will lead to total disaster. To escape from such a scenario, reconstruction is necessary. To a certain extent, reconstruction is remedy to avoid unforeseen disaster to companies. Proper diagnosis and reorganization may alleviate such evils.

11.2 Methods of Internal Reconstruction

The following are the methods employed for internal reconstruction:

1. Alteration of share capital
2. Reduction of share capital
3. Compromise/arrangement as per Sections 391 to 394(A)
4. Variation of shareholder's rights
5. Surrender of shares
6. Cancellation of unissued shares

1. Alteration of share capital:

Under this method, alteration of share capital involving increase, consolidation or sub-division of sharecapital is done according to Section 94, 95 and 97 of the Companies Act.Alteration will not involve reduction of share capital. Any public limited company can alter the capitalclause of its Memorandum of Association (i) if it is authorized by its Articles of Association to carry outalteration and (ii) by an ordinary resolution passed in its general meeting. Alteration of share capital can becarried out in the following ways:

A) Increase of Share Capital

A company may increase its share capital by issuing new shares:

Accounting Entries: (Full Amount Payable on Application)

(i) Bank A/c Dr.

To Share Application & Allotment A/c

(ii) Share Application & Allotment A/c Dr.

To Share Capital A/c

B) Consolidation of Shares

In this type, the existing shares of lower denomination are converted into shares of higher denomination.

Accounting Entry:

Share (Equity or…. % Preference) Capital A/c Dr.

To Share (Equity or ……% Preference) Capital A/c

Example: A company having 1,00,000 12% preference shares of Rs. 10 each decided to consolidate the shares into shares of ` 100 each. Pass the needed journal entry.

Date	**Particulars**	**LF**	**Dr.**	**Cr.**
	12% Preference Share Capital (1,00,000 × 10) Dr. To 12% Preference Share Capital (10,000 × 100)		10,00,000	 10,00,000

	(Consolidation of 1,00,000 Pref. Shares of 10 into 10,000 Preference Shares of 100 Each)			

One should note here that the paid up share capital remains the same, i.e. Rs. 10,00,000 only, but total number of shares is reduced to 10,000 from 1,00,000 shares. The face value of shares is increased from Rs. 10 to Rs. 100.

Care should be taken in case of partly paid shares to keep the proportion between the paid-up and unpaid amount at the same level after consolidation.

Example: A company with a subscribed capital of Rs. 1,00,000 divided into 10,000 equity shares of Rs. 10 each on which Rs. 6 per share are paid up. The company decides to consolidate equity shares of ` 10 each into Rs.100 each. Pass the journal entry.

Date	Particulars	LF	Dr.	Cr.
	Equity Share Capital A/c (10,000 × 6) Dr.		60,000	
	To Equity Share Capital A/c (1,000 × 60)			60,000
	(Consolidation of 10,000 Equity Shares of 10 Each (6 Paid up)into 1,000 Equity Shares of 100 Each (60 Paid up)			

NOTE: After consolidation, there is no change in the paid-up share capital i.e. Rs.60,000. But the number of shares and its face value have changed. Paid-up value is also increased proportionately from Rs. 6 to Rs. 60

C) Conversion of Fully Paid Shares into Stock

In this case, all or any of its fully paid shares may be converted into one unit of stock.

Example: A company decided to convert its 10,000 equity shares of Rs. 10 each into Rs. 1,00,000 equity stock. Pass the entry.

Date	Particulars	LF	Dr.	Cr.
	Equity Capital A/c Dr.		1,00,000	
	To Equity Stock A/c			1,00,000
	(Conversion of 10,000 EquityShares of Rs.10 Each Fully Paid upinto Rs. 1,00,000 Equity Stock (One Unit)			

D) **Reconversion of Stock into Shares (Fully Paid up)**

Stock (of one unit) may be converted into shares.

Example: Rs. 1,00,000 equity stock is converted into 1,000 equity shares of Rs.100 each fully paid. Pass the entry

Date	Particulars	LF	Dr.	Cr.
	Equity Capital A/c Dr.		1,00,000	
	To Equity Share capital A/c			1,00,000
	(Rs. 1,00,000 Equity Stock Is Converted into 1,000 Equity			

	Sharesof Rs. 100 Each)	LF		

E) **Sub-division of Shares**

A company may sub-divide its shares of higher denomination into shares of smaller denomination.

Example: A company has 5,000 equity shares of Rs. 100 each. It decides to sub-divide these shares into Rs. 10 each. Pass the required journal entry:

Date	Particulars	LF	Dr.	Cr.
	Equity Capital A/c Dr.		5,00,000	
	To Equity Share capital A/c (Rs. 500)			5,00,000
	(5,000 Equity Shares of Rs.100 Each Sub-divided into 50,000 Shares of Rs.10 Each)			

Paid-up capital remains unaffected whereas the face value of shares is reduced and the number of shares is increased.

F) **Cancellation of Unissued Shares**

Shares which have not been issued (till date) by the company are cancelled. These unissued shares are neither taken by any person nor agreed to be taken by any one.On cancellation of unissued shares, the amount of share capital will be reduced to that extent that it only results in diminution of authorized share capital and it does not mean reduction share capital.

Example: A limited company has an authorized capital of ` 10,00,000 and issued capital of Rs. 7,50,000.

It decides to alter its authorized capital (for unissued shares cancelled) to Rs. 7,50,000 and issued capital to Rs. 7,50,000

There is no accounting entry for any cancellation of unissued shares. The reduced authorized capital is to be shown in the balance sheet of next accounting year only.

2. Reduction of share capital:

A Company can reduce its share capital as per the provisions of the Companies Act. Sections 100 to 105 ofthe Act laid down certain provisions with respect to reduction of capital. The following is the procedure tobe followed for effecting reduction of share capital:

1. There should be a specific clause relating to reduction of share capital in the Articles of Association.

2. In case the articles of association are silent on this matter, a special resolution has to be passed to effectreduction of share capital in the general meeting.

3. Court order has to be obtained for any reduction in share capital. (It should be observed here that foralteration of share capital, court permission is not necessary.)

4. A copy of special resolution in reduction of share capital and the order of confirming such reductionmust be filed with the Registrar of Companies.

Accounting Treatment for Capital Reduction

Reduction of share capital may take place in more than one form.

Form 1: Reducing the liability or extinguishing entirely the liability of the shareholders with respect touncalled or unpaid amount.When the uncalled amount of the share capital is reduced or entirely extinguished, the shareholderswill be exempted from paying that amount to that extent in future. The shareholders are benefitted by suchform of reduction of share capital.

Example: A company whose capital consists of 1,000 shares of 100 each, 75 called and paid, decides to reduce the shares into 1,000 shares of Rs. 75 each fully paid. Pass journal entry.

Date	Particulars	LF	Dr.	Cr.
	Share Capital A/c (1,000 × Rs. 75) Dr. To Share Capital A/c (Conversion of 1,000 Shares of Rs. 100 Each Rs. 75 (Partly) Paidup into 1,000 Shares of Rs. 75 Each Fully Paid up)		75,000	75,000

Net result: (i) Reduction in nominal value; (ii) No reduction in paid-up value.

Form 2—Refunding surplus capital: At times, some companies may be confronted with the problem ofexcess capital. Hence the company is forced to refund the excess capital to its members. The members willraise vehement objections because it will affect the security enjoyed by the creditors. Such a scheme ofcapital requiring the refund of surplus capital needs the approval of the Court.

(i) Share Capital A/c Dr.

To Sundry Shareholder's A/c

(ii) Sundry Shareholder's. A/c Dr.

To Bank A/c

Example: A company whose paid-up capital includes 5,000 equity shares of 100 each fully paid decides to return 25 per share to the members, this reducing each share to 75 each, fully paid. Pass entries.

Date	Particulars	LF	Dr.	Cr.
	Equity Share Capital(Rs 100) A/c Dr. To Equity Share Capital (Rs 75) A/c To Sundry Shareholders' A/c (Conversion of 5,000 Shares of Rs 100 Each into Shares ofRs 75 Each and the Balance to Be Refunded Transferred to theMembers)		3,75,000	 375000 125000
	Sundry Shareholders A/c Dr. To Bank A/c (Refund of Surplus Capital on Account of Reduction of Capital to the Shareholders)		1,25,000	 125000

Net result: The share capital of the company will be reduced by the amount refunded. In this problem, the share capital is reduced from Rs. 5,00,000 to 3,75,000 because of the refund of Rs. 1,25,000 to the shareholders.

Form 3—Reducing the paid up capital (Writing off of lost capital not represented by assets):

The share capital of the company which has been facing losses for a considerable period, usually continuously for a long period, may not be truly represented by the assets.

The extent of loss will also get reflected in the form of goodwill, over-valuation of assets, etc. Hence, in the scheme of capital reduction, it is essential to write off or cancel that portion of capital which is already lost, not represented by assets accounting treatment.

A new account—reconstruction A/c or capital reduction A/c—has to be opened. The amount of reduction has to be credited to this account. This scheme of capital reduction may be carried out in the following two situations:

Situation 1—Reduction in the paid-up value and nominal value:

In this case, the nominal value of the shares and the paid-up value is reduced.

Example: In a limited company, the shareholders agree to reduce the paid-up capital of 100 per share (10,000 shares) to fully paid shares of 60 per share. Pass entries.

Date	**Particulars**	**LF**	**Dr.**	**Cr.**
	Equity Share Capital A/c (Rs 100) Dr.		10,00,000	
	To Equity Share Capital A/c (Rs 60)			600000
	To Reconstruction A/c			400000
	or			
	To Capital Reduction A/c			
	(Conversion of 10,000 Shares of Rs 100 Each into Shares ofRs 60 Fully paid, and the Balance Transferred to ReconstructionA/c or Capital Reduction A/c)			

Situation 2—Reduction in the paid-up value only: In this case, the nominal value of the shares remains the same. But the paid-up value is reduced.

Example: A company decides to reduce 30 per share on its 50,000 equity shares of 100 each fully paid.Pass the required journal entry.

Date	Particulars	LF	Dr.	Cr.
	Equity Share Capital A/c Dr.		15,00,000	
	To Reconstruction A/c			1500000
	(Reduction of Rs 30 per Share on 50,000 Shares of Rs 100 Each asper Capital Reduction Scheme)			

11.3 Accounting treatment related to internal reconstruction

Specimen of Reconstruction Account

Particulars	**Rs.**	**Particulars**	**Rs.**

P & L A/c (Loss Written off)	**-**	**Share Capital Account**	**-**
Intangible Assets Account	**-**	**(Reduction in Paid-up Value)**	
(Useless Intangible Assets Written off —Individually)		**Debentures Account**	**-**
		(Amount ofReduction)	
Miscellaneous Expenditures	**-**	**Creditors Account**	**-**
(Written off —Each Expense Individually)		**(Amount of Sacrifice)**	
		Fixed Assets Account	**-**
Discount on Issue of Shares	**-**	**(Increase in Value)**	
(Written off)		**Current Assets Account**	**-**
Discount on Issue of Debentures	**-**	**(Increase in Value**	
(Written off)		**Bank Account**	**-**
Fixed Assets A/c	**-**	**(Sale Amount of Unrecorded Assets)**	
(Decrease in Value—Individually)		**Reserves Account**	**-**
Current Assets A/c	**-**	**Provisions Account**	**-**
(Decrease in Value—Individually)		**(To the Extent Not Required)**	
Provision for Doubtful Debts	**-**		
Bank Account	**-**		
(Unrecorded Liability—Paid)			
Bank Account	**-**		
(Arrears of Pref. Dividend—Paid)			
Bank Account	**-**		
(Reconstruction expenses—Paid) ...			
New Liability Account	**-**		
Bank Account	**-**		
(Directors' Fees Refunded)			
Capital Reserve A/c (If Any) (Bal. Fig.)	**-**		

Balance sheet after reconstruction

The factors that should be taken into account while preparing the balance sheet after the completion of internal reconstruction are as follows:

1. The words "And Reduced" must be added to the name of the company. This should be continued for certain accounting period as ordered by the court.

2. (i) The revised appreciated values of the assets on the date of internal reconstruction must be shown in the balance sheet. The book values should be ignored.

(ii) The amount of increase in the value of assets on account of revaluation should be shown in the balance sheet.

(iii) The revised lower figures, i.e., original cost-depreciation should be shown instead of book values.

3. (i) For fixed assets, the amount written off should be shown separately for a period of 5 years.

(ii) For current assets, and investments, the amount written off need not be shown. They should be shown only at their revised lower values.

(iii) For provisions, such amount of provision should be shown as a deduction from the gross amount in the inner column and only the net amount in the outer column.

Illustration 1: Model: Alteration of share capital

Raj Co. Ltd. has the following shares as a part of its share capital:

(i) 20,000 10% Preference shares of Rs. 100 each fully paid

(ii) 1,00,000 Equity shares of Rs. 5 each fully paid

(iii) 40,000 Equity shares of Rs. 10 each, Rs. 7.50 called and paid up

The Company has decided to alter the share capital as follows:

(a) To sub-divide the preference shares into shares of Rs. 10 each.

(b) To consolidate the equity shares of Rs. 5 each into shares of Rs. 10 each.

(c) To convert the partly paid-up equity shares into fully paid-up shares of Rs. 7.50 each, with necessary legal sanctions.

Journalize the alterations.

Solution:

Books of Raj Co. Ltd.

Journal Entries

Date	Particulars	LF	Dr.	Cr.
	10% Preference Share Capital (Rs. 100) A/c Dr. To 10% Preference Share Capital (Rs. 10) A/c (20,000 10% Preference Shares of Rs. 100 Each Are Sub-dividedinto 2,00,000 10% Preference Shares of Rs. 10 Each)		2000000	2000000
	Equity Share Capital (Rs. 5) A/c (1,00,000 × 5) Dr. To Equity Share Capital (Rs. 10) A/c (50,000×10) (1,00,000 Equity Shares of Rs. 5 Each Are Consolidated into 50,000 Equity Shares of Rs. 10 Each		500000	500000
	Equity Share Capital A/c (40,000 × Rs. 7.50) Dr. (Partly Paid) To Equity Share Capital A/c (40,000 × Rs. 7.50) (Fully Paid) (Partly Paid Shares Are Converted into Fully Paid Shares)		300000	300000

Illustration 2: Model: Surplus in capital reduction

XYZ Co. Ltd. passed resolution and got Court permission for the reduction of its share capital by Rs. 2,50,000 for the purposes mentioned in the following:

(i) To write off the debit balances of P&L A/c of Rs. 1,05,000

(ii) To reduce the value of plant & machinery by Rs. 45,000 and goodwill by Rs. 20,000

(iii) To reduce the value of investments by Rs. 40,000

The reduction was made by converting 25,000 preference shares of Rs. 20 each fully paid to the same number of preference shares of Rs. 15 each fully paid and by converting 25,000 equity shares of Rs. 20 each on which Rs. 15 is paid up into 25,000 equity shares of Rs. 10 each fully paid up.

Pass journal entries to record the share capital reduction.

Solution: **Books of XYZ Co. Ltd.**

Journal Entries

Date	Particulars	LF	Dr.	Cr.
	Preference Share Capital A/c (Rs. 20) Dr. To Preference Share Capital A/c (Rs. 15)		500000	375000

	To Capital Reduction A/c (25,000 Preference Shares of Rs. 20 Each Fully Paid Are Converted into Preference Shares of Rs. 15 Each Fully Paid and the Balance Transferred to Capital Reduction A/c)			125000
	Equity Share Capital (Partly Paid) A/c Dr. To Equity Share Capital (Fully Paid) A/c To Capital Reduction A/c (25,000 Partly Paid Equity Shares into Fully Paid Shares and the Balance Transferred to Capital Reduction A/c)		375000	 2,50,000 125000
	Capital Reduction A/c Dr. To P&L A/c To Plant & Machinery A/c To Goodwill A/c To Investments A/c To Capital Reserve A/c (Bal. Fig.) (Losses Written off , Assets Written down and the Balance Transferred to Capital Reserve) Note: Capital Reduction A/c; Reconstruction A/c and Reorganization A/c All Represent the Same Meaning		250000	 105,000 45000 20000 40000 40000

Illustration 3: Capital reduction A/c (Reconstruction A/c) Issue of new debentures

The following scheme of reconstruction has been legally approved for Bhagya Ltd:

1. In lieu of their present holding of 1,20,000 shares of Rs. 10 each fully paid, the shareholders are to receive the following:

(i) Fully paid new equity shares equal to one-third of their holding

(ii) 10% Preference shares fully paid to the extent of one-fi fth of the above new equity shares

(iii) Rs. 1,20,000, 10% secured debenture

2. The debenture holders' total claim of Rs. 1,50,000 to be reduced to Rs. 50,000. This will be satisfied by issue of 5,000 10% preference shares of Rs. 10 each fully paid.

3. An issue of Rs. 1,00,000 5% first debentures was made and allotted, payment for the same having been received in cash.

4. The goodwill which stood at Rs. 6,00,000 was written down to Rs. 1,00,000. Plant & machinery which stood at Rs. 2,00,000 was written down to Rs. 1,50,000.

5. The freehold premises which stood at Rs. 3,50,000 was written down by Rs. 1,50,000.

Given the journal entries in the books of Bhagya Ltd. for the above reconstruction scheme.

Solution:

Books of Bhagya Ltd.

Journal Entries

Date	Particulars	LF	Dr.	Cr.

	Equity Share Capital(Rs. 10) A/c Dr. To Equity Share Capital (New) A/c To 10% Preference Share Capital A/c To 10% Secured Debentures A/c To Reconstruction A/c (New Equity Shares; 1/3 × 1,20,000 Shares 40,000 Equity Shares, Rs. 4,00,000 New Preference Shares; 1/5 × 40,000 Shares 8,000 Preference Shares; Rs. 80,000 40,000 equity shares; 8,000 10% Pref. Shares; Rs.1,20,000 10% Debentures Issued and the Balance of Old Share Capital Rs. 6,00,000 Transferred to Reconstruction A/c)		1200000	 400,000 80000 120000 600000
	Debentures A/c Dr. To 10% Preference Share Capital A/c To Reconstruction A/c (Claim of Debenture Holders Reduced to Rs. 50,000 and the Balance Transferred to Reconstruction A/c (Capital Reduction A/c)		150000	50000 100000
	Reconstruction A/c Dr. To Goodwill A/c To Plant & Machinery A/c To Freehold Premises A/c (Value of Various Assets Are Reduced as per Scheme of Reconstruction)		7,00,000	 5,00,000 50,000 1,50,000
	Bank A/c Dr. To 8% First Debentures A/c (New Debentures Issued)		1,00,000	 1,00,000

Summary

Internal reconstruction is concerned with theassessment of the financial position of a companyby revaluation of assets and liabilities to their truevalues.

Need for reconstruction: (i) To reflect a trueand fair view of financial position (ii) To updatethe value of assets by eliminating fictitious andvalueless intangible assets and bringing down thevalue of assets to their true value (iii) To correctoverride liabilities (iv) To ascertain real value ofthe net assets and (v) For a proper diagnostic andremedial measure.

Methods of internal reconstruction: (i) Alterationof share capital (ii) Reduction of share capital (iii) Variation of shareholders' rights (iv) Compromiseor arrangement and (v) Surrender of shares.

Accounting treatment for each method ofinternal reconstruction is explained in detail in themain part of the text. Reconstruction account—Preparation and utilization: For details refer text.

Preparation of balance sheet after reconstruction:Important factors to be taken into account: (i) Nameof the company … (And reduced) (ii) To showrevised appreciated figures in the valuation ofassets and (iii) Strict compliance with the rules foramounts written off.

Keywords

Internal Reconstruction: A scheme of re-organization of the company (Corrections on the value of assets and liabilities) without liquidation of the company.

Alternation of Share Capital: It involves increase, consolidation or sub-division of share capital. It does not involve reduction of share capital.

Reconstruction Account: The account to be prepared during the process of scheme of internal reconstruction.

Self Assessment

1. Only unsuccessful companies can undertakecapital reduction.

A. True
B. False

2. Internal reconstruction means reorganization ofcapital structure of a company by liquidating thecompany.

A. True
B. False

3. Consolidation of shares will result in reduction innumber of shares.

A. True
B. False

4. The authorized capital gets reduced, to the extentof unissued shares cancelled.

A. True
B. False

5. Cancellation of unissued capital is not a case ofcapital reduction.

A. True
B. False

6. Ordinary resolution will be sufficient forreduction of share capital.

A. True
B. False

7. Consent of the creditors is required for return ofcapital.

A. True
B. False

8. Amounts sacrificed by shareholders are creditedto capital reserve A/c.

A. True
B. False

9. In a scheme of reorganization, the amount ofshares surrendered by shareholders is transferredto reconstruction.

A. True
B. False

10. A company is free to reduce or extinguish theuncalled liability of its members.

A. True
B. False

Answer for Self Assessment

1.	A	2.	B	3.	B	4.	A	5.	B
6.	B	7.	A	8.	B	9.	B	10.	B

Review Questions

1 Name the two types of alteration of the share capital of a company.

2. What do you mean by "internal reconstruction"?

3. What is meant by "external reconstruction"?

4. What are the differences between "internal" and "external" reconstruction?

5. "Internal reconstruction" is preferred by companies—Why?

6. Enlist the different forms of reduction of capital.

7. Elucidate the different kinds of alterations of share capital with required accounting entries.

. Explain the procedure to be adopted for reduction of share capital.

8. The share capital of VIR Ltd. consisted of the following:

(a) 30,000 6% Preference shares of Rs. 100 each and

(b) 1,50,000 Equity shares of Rs. 10 each

(c) The shares were fully paid

The company had accumulated losses totaling Rs. 10,50,000 besides preliminary expenses of Rs. 60,000. It was also ascertained that fixed assets which stood in the books at Rs. 42,00,000 were over-valued to the extent of Rs. 12,00,000. The following scheme was adopted to write off the losses and reduce the assets:

(i) 6% Preference shares were to be converted into 7% pref. shares of Rs. 60 each

(ii) Equity shares were to be reduced to Rs. 2 each.

Journalize.

9. The following scheme of reconstruction has beenduly approved:

(i) The shareholders to receive the following inlieu of their present holding of 25,000 sharesof Rs 10 each:

(a) Fully paid equity shares equal to twofifths of their holding

(b) 10% Preference shares, fully paid, tothe extent of one-fifths the above newequity shares

(c) Rs 30,000 14% second debentures

(ii) An issue of Rs 25,000 12% first debentureswere made and allotted, payment for the samebeing received in cash forth with

(iii) Goodwill which stood at Rs 75,000 wascompletely written off

(iv) Plant & machinery which stood at Rs 50,000was written down to ` 37,500

(v) Freehold & leasehold premises whichstood at Rs 87,500 were written down toRs 75,000

Give journal entries in the books of the companynecessitated by the above reconstruction.

Further Readings

- Jain, R., & Narang, K. L. (2009). Corporate Accounting. Tulsian, P. C., Financial accounting, Pearson Education, India.
- Nitin Balwani, Accounting & Finance for Managers, Excel Books, New Delhi.
- Collier, P. M., Accounting for managers: Interpreting accounting information for decision making, John Wiley & Sons.
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Unit 12:Statement of Changes in Equity

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- The financial statement presentation
- The International Financial Reporting standards in SMEs
- The impact of changes in accounting policies in accounting
- The format of statement of change in equity

Introduction

IAS 1 Presentation of Financial Statements sets out the overall requirements for financial statements, including how they should be structured, the minimum requirements for their content and overriding concepts such as going concern, the accrual basis of accounting and the current/non-current distinction. The standard requires a complete set of financial statements to comprise a statement of financial position, a statement of profit or loss and other comprehensive income, a statement of changes in equity and a statement of cash flows.

IAS 1 was reissued in September 2007 and applies to annual periods beginning on or after 1 January 2009

12.1 History of IAS 1

Date	Development	Comments
March 1974	Exposure Draft E1 Disclosure of Accounting Policies	
January 1975	IAS 1 Disclosure of Accounting Policies issued	Operative for periods beginning on or after 1 January 1975
June 1975	Exposure Draft E5 Information to Be Disclosed in Financial Statements published	
October 1976	IAS 5 Information to Be Disclosed in Financial Statements issued	Operative for periods beginning on or after 1 January 1975
July 1978	Exposure Draft E14 Current Assets and Current Liabilities published	
November 1979	IAS 13 Presentation of Current Assets and Current Liabilities issued	Operative for periods beginning on or after 1 January 1981
1994	IAS 1, IAS 5, and IAS 13 reformatted	
July 1996	Exposure Draft E53 Presentation of Financial Statements published	
August 1997	IAS 1 Presentation of Financial Statements (1997) issued (Supersedes IAS 1 (1975), IAS 5, and IAS 13 (1979))	Operative for periods beginning on or after 1 July 1998
18 December 2003	IAS 1 Presentation of Financial Statements (2003) issued	Effective for annual periods beginning on or after 1 January 2005
18 August 2005	Amended by Amendment to IAS 1 — Capital Disclosures	Effective for annual periods beginning on or after 1 January 2007
16 March 2006	Exposure Draft Proposed Amendments to IAS 1 – A Revised Presentation published	Comment deadline 17 July 2006
22 June 2006	Exposure Draft Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation published	Comment deadline 23 October 2006
6 September 2007	IAS 1 Presentation of Financial Statements (2007) issued	Effective for annual periods beginning on or after 1 January 2009
14 February 2008	Amended by Puttable Financial Instruments and Obligations Arising on Liquidation	Effective for annual reporting periods beginning on or after 1 January 2009
22 May 2008	Amended by Annual Improvements to IFRSs 2007 (classification of derivatives as current or non-current)	Effective for annual reporting periods beginning on or after 1 January 2009
16 April 2009	Amended by Improvements to IFRSs 2009 (classification of liabilities as current)	Effective for annual periods beginning on or after 1 January 2010

6 May 2010	Amended by Improvements to IFRSs 2010 (clarification of statement of changes in equity)	Effective for annual periods beginning on or after 1 January 2011
27 May 2010	Exposure Draft ED/2010/5 Presentation of Items of Other Comprehensive Income published	Comment deadline 30 September 2010
16 June 2011	Amended by Presentation of Items of Other Comprehensive Income	Effective for annual periods beginning on or after 1 July 2012
17 May 2012	Amended by Annual Improvements 2009-2011 Cycle (comparative information)	Effective for annual periods beginning on or after 1 January 2013
18 December 2014	Amended by Disclosure Initiative (Amendments to IAS 1) (project history)	Effective for annual periods beginning on or after 1 January 2016
31 October 2018	Amended by Definition of Material (Amendments to IAS 1 and IAS 8)	Effective for annual periods beginning on or after 1 January 2020
23 January 2020	Amended by Classification of Liabilities as Current or Non-current (Amendments to IAS 1)	Effective for annual periods beginning on or after 1 January 2022
15 July 2020	IASB defers effective date of Classification of Liabilities as Current or Non-current (Amendments to IAS 1) to 1 January 2022	The new effective date of the January 2020 amendments is now 1 January 2023
31 October 2022	Amended by Non-current Liabilities with Covenants (Amendments to IAS 1)	Effective for annual periods beginning on or after 1 January 2024; the effective date of the January 2020 amendments is also pushed to 1 January 2024

12.2 Financial Statement Presentation

As per Ind AS 1, a complete set of financial statements comprises:

1. A statement of profit and loss for the period.
2. A balance sheet at the end of the period.
3. Statement of changes in equity for the period.
4. A statement of cash flows for the period.
5. Notes—comprising a summary of significant accounting policies and otherexplanatory information.

To ensure uniformity in the presentation of financial statements, the formats for thestatement of profit and loss and the balance sheet have been prescribed in the ScheduleIII of the Companies Act, 2013. The Schedule III also includes general instructions forthe preparation of financial statements.

Accordingly, it is mandatory to present current year figures and the comparative figuresof the previous year. The figures in financial statements may be rounded off dependingupon the turnover of the company. If the turnover is less than 100 crore, the figuresmay be rounded off to the nearest hundreds, thousands, lakh or millions. If, however, itis 100 crore or more, rounding off is permitted in the nearest lakh, millions or crore.

Each entry in the balance sheet, statement of changes in equity and statement of profitand loss is required to be cross-referencedwith the related information in the notes.

All material items—information that individually or collectively could be relevant fordecision making by users—shall be disclosed. At the same time, excessive disclosuresshall be avoided. Materiality of an item should be judged in the particularcircumstances considering the size or nature of the item or a combination of both. Inaddition, disclosures required by any law or regulation shall also be made.

12.3 Objective of IAS 1

The objective of IAS 1 (2007) is to prescribe the basis for presentation of general-purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. IAS 1 sets out the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. [IAS 1.1] Standards for recognizing, measuring, and disclosing specific transactions are addressed in other Standards and Interpretations.

12.4 Scope of IAS 1

IAS 1 applies to all general-purpose financial statements that are prepared and presented in accordance with International Financial Reporting Standards (IFRSs).

General purpose financial statements are those intended to serve users who are not in a position to require financial reports tailored to their particular information needs.

12.5 Objective of Financial Statements

The objective of general-purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about an entity's:

- assets
- liabilities
- equity income and expenses, including gains and losses
- contributions by and distributions to owners (in their capacity as owners)
- cash flows.

That information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

12.6 Statement of Change in Equity

Schedule III requires a separate 'statement of change in equity' to be presented comprising equity share capital and other equity. Other equity includes all items other than equity shares that are attributable to the holders of equity instruments of an entity. The statement of change in equity represents a reconciliation of equity, shows balances in the beginning of the year, changes occurred during the year, and balances at the end of the year. Ind AS 1 requires such reconciliation for each component of equity showing separately changes resulting from:

1. profit or loss;
2. other comprehensive income;
3. transactions with owners in their capacity as owners, showing separately contributions by, and distributions to owners and changes in the ownership interests in subsidiaries that do not result in a loss of control; and
4. any item recognized directly in equity.

The balance sheet depicts the equity balance at the end of the accounting period. The statement of change in equity identifies the reasons for change in the various components of equity during the year. The primary reasons for change in equity are profit or loss for the year, other comprehensive income for the year, distribution of dividend to the shareholders, issue of fresh shares, buyback of shares and any direct adjustment in the equity balances.

12.7 IFRS for Small and Medium Entities (SMEs)

International Accounting Standards Board (IASB) commences second comprehensive review of the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). IFRS for SMEs Standard are applied for general purpose financial statements of small companies, primarily; small and medium-sized entities (SMEs), private entities and non-publicly accountable entities, which is required or permitted in 86 jurisdictions across the globe. This Standard is based on full IFRS with modifications to reflect the needs of users of SMEs' financial statements and cost-benefit considerations. It focuses on the information needs of lenders, creditors and other users of SME financial statements who are interested primarily in information about cash flows, liquidity and solvency.

In 2009, the International Accounting Standards Board (IASB) issued the first edition of International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs Accounting Standards). The IASB maintains the SMEs Standards through periodic review and proposes amendments by publishing an omnibus exposure draft. In developing these exposure drafts, it considers new and amended IFRS Accounting Standards as well as issues brought to its attention regarding the application of the Standard.

In 2015, the IASB completed its first comprehensive review of the Standard. It issued 2015 Amendments to the IFRS for SMEs and a second edition of the Standard, incorporating the 2015 amendments, which became effective in 2017.

In 2019, the IASB conducted its second comprehensive review of the SMEs Standard, in line with the objective of commencing a comprehensive review approximately two years after the effective date of the amendments to the SMEs Standard resulting from a previous comprehensive review. As part of this second comprehensive review, the IASB published Request for Information Comprehensive Review of the IFRS for SMEs Standard as a first step in its second comprehensive review and consulted with the SME Implementation Group (SMEIG), an advisory body to the IASB. The objective of the Request for Information was to seek views on whether and, if so, how aligning the SMEs Standard with new and amended full IFRS Accounting Standards in the scope of the review to better serve users of financial statements prepared applying the SMEs Standard without causing undue cost or effort for SMEs.

After considering the feedback on the Request for Information and the recommendations of the SMEIG, the IASB is proposing amendments to the IFRS for SMEs Accounting Standard set out in the following Exposure Draft:

Third edition of the IFRS for SMEs Accounting Standard

Though India will not be directly affected with changes happening in IFRS for SMEs Standards, however, with the view to contribute to standard setting at international level, the Exposure Draft of the third edition of the IFRS for SMEs Accounting Standard issued by the IASB.

Invitation to comment

The Accounting Standards Board (ASB) of ICAI with the aim to provide an opportunity to the various stakeholders in India to raise their concerns at the initial International Standard-setting stage itself, invites comments from public.

12.8 The IFRS for SMEs Accounting Standard

The IFRS for SMEs Accounting Standard reflects five types of simplifications from full IFRS Accounting Standards:

some topics in full IFRS Accounting Standards are omitted because they are not relevant to typical SMEs;

some accounting policy options in full IFRS Accounting Standards are not allowed because a more simplified method is available to SMEs;

many of the recognition and measurement principles that are in full IFRS Accounting Standards have been simplified;

substantially fewer disclosures are required; and

the text of full IFRS Accounting Standards has been redrafted in 'plain English' for easier understandability and translation.

The IFRS for SMEs Accounting Standard includes an option for entities to apply the recognition and measurement requirements of IAS 39 Financial Instruments: Recognition and Measurement.

12.9 The IFRS for SMEs Accounting Standard and IAS 39

The IFRS for SMEs Accounting Standard includes an option for entities to apply the recognition and measurement requirements of IAS 39 Financial Instruments: Recognition and Measurement. If an entity chooses this option, the applicable version of IAS 39 is explained below:

For accounting periods beginning before 1 January 2018, an SME shall apply the version of IAS 39 that is in effect at its reporting date, by reference to the full IFRS Accounting Standards publication titled IFRS® Standards Consolidated without early application (Blue Book).

For accounting periods beginning on or after 1 January 2018 an SME shall apply the version of IAS 39 that applied immediately prior to the effective date of IFRS 9 Financial Instruments.

12.10 Changes in Accounting Policies

Accounting policies are the accounting principles and method of applying those principles while preparing the financial statements. A change in accounting policy should be undertaken only in two cases:

i. If the change is required by law or accounting standard; or

ii. If the change helps in better presentation of financial statements

Any change in an accounting policy which has a substantial/material effect has to be disclosed necessarily. The impact of such change should also be shown in financial statements. If the impact can't be assessed, this fact should also be disclosed.

An entity shall change an accounting policy only if the change:

(a) is required by an Ind AS; or

(b) results in the financial statements providing reliable and more relevant

information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

The following are not changing in accounting policies:

(a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and

(b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

12.11 Format of Statement of change in Equity

In addition to the presentation of balance sheet at the end of the accounting period, an entity is also required to separately present a statement of change in equity. The statement of change in equity essentially provides a reconciliation of equity share capital and all items of other equity. The statement is broken into two parts. The part of equity share capital provides details regarding balance at the beginning of the period, changes in equity shares capital during the year and balance at the end of the reporting period. Likewise, the part for Other Equity provides a reconciliation during a particular reporting period, as a part of one single statement, of all items other than equity share capital, that are attributable to the holders of equity instruments of an entity. The statement is prepared in columnar form with the following details:

- Share application money pending allotment
- Equity component of compound financial instruments
- Reserves and surplus
    a. Capital reserve
    b. Securities premium reserve
    c. Other reserves (specify nature)
    d. Retained earnings
- Debt instruments at fair value through other comprehensive income
- Equity instruments at fair value through other comprehensive income
- Effective portion of cash flow hedges
- Revaluation surplus
- Exchange differences on translating the financial statements of a foreign operation
- Other items of other comprehensive income (specify nature)
- Money received against share warrants

The statement of change in equity provides a comprehensive view of changes in equity during the accounting period. The statement of change in Equity of Biocon Limited for the year ended 31st March 2017 is given in Table 1

Table 1: Statement of Change in Equity of Biocon Limited as on 31st March 2017

	(₹ in Million)	
	31st March 17	31st March 16
A. Equity Share Capital		
Opening Balance	1,000	1,000
Changes in equity share capital	–	–
Closing Balance	1,000	1,000

B. Other Equity

Particulars	Securities Premium Reserve	Revaluation Reserve	General Reserve	Retained Earnings	SEZ Reinvestment Reserve	Share-based Payment Reserve	Treasury Shares	Cash flow Hedging Reserves	Other Items of OCI	Total Other Equity
Balance at March 31, 2016	**2,788**	**9**	**3,458**	**52,858**	**0**	**435**	**–577**	**0**	**–5**	**58,966**
Profit for the year	0	0	0	5,193	0	0	0	0	0	5,193
OCI, net of tax	0	0	0	0	0	0	0	102	–18	84
Transactions recorded directly in equity										
Share based payment	0	0	0	0	0	125	0	0	0	125
Purchase of Treasury shares	0	0	0	0	0	0	–150	0	0	–150
Transfer to SEZ reinvestment reserve	0	0	0	–162	162	0	0	0	0	0
Transfer from SEZ reinvestment reserve on utilisation	0	0	0	162	–162	0	0	0	0	0
Exercise of share options	120	0	0	193	0	–120	0	0	0	193
Balance at March 31, 2017	**2,908**	**9**	**3,458**	**58,244**	**0**	**440**	**-727**	**102**	**–23**	**64,411**

Summary

The information presented in financial and other reports, including the financial statements, notes, and management's commentary, help the financial analyst to assess a company's performance and financial position. An analyst may be called on to perform a financial analysis for a variety of reasons, including the valuation of equity securities, the assessment of credit risk, the performance of due diligence in an acquisition, and the evaluation of a subsidiary's performance relative to other business units. Major considerations in both equity analysis and credit analysis are evaluating a company's financial position, its ability to generate profits and cash flow, and its ability to generate future growth in profits and cash flow.

The statement of comprehensive income includes all items that change owners' equity except transactions with owners. Some of these items are included as part of net income, and some are reported as other comprehensive income (OCI).

The statement of changes in equity provides information about increases or decreases in the various components of owners' equity.

Keywords

- Indian Accounting Standard (Ind AS)
- International Financial Reporting Standard (IFRS)

- Statement of change in equity
- Financial statement analysis
- Financial statement presentation
- SMALL and MEDIUM ENTITIES (SMEs)

Self Assessment

1. In the statement of changes in equity, the effects of the retrospective application of a change in accounting policy is presented

A. In aggregate for total equity.

B. Separately for each component of equity.

C. Separately for the total amount attributable to owners of parent and the noncontrolling interest

D. In aggregate for total equity and separately for the total amount attributable to owners of the parent and the noncontrolling interest.

2. In the statement of changes in equity, the effects of the correction of a prior period error are presented

A. In aggregate for total equity.

B. Separately for each component of equity

C. Separately for the total amount attributable to owners of the parent and the noncontrolling interest.

D. In aggregate for total equity and separately for the total amount attributable to owners of the parent and the noncontrolling interest.

3. This is defined as "holders of instruments classified as equity".

A. Equity holders

B. Investors

C. Owners

D. Shareholders

4. Which of the following should be presented in the statement of changes in equity?

A. Distributions to owners

B. Investments by owners

C Change in ownership interest in subsidiary that does not result in a loss of control

D. All of these are presented in the statement of changes in equity

5. Which of the following would appear first in a statement of retained earnings?

A. Cash dividend

B. Net income

C. Prior period error

D. Share dividend

6. Which of the following does not appear in a statement of retained earnings?

A. Net loss

B. Other comprehensive income

C. Preference share dividend

D. Prior period error

7. Which occurrence would directly affect retained earnings?

A. Goods purchased deemed worthless in the current year.

B. Collection in the current year of a dividend from an investment.

C. Sale in the current year of land donated by a shareholder in a prior year.

D. Correction of an error in the financial statements of a prior period discovered subsequent to issuance

8. An entity made a very large arithmetical error in the calculation of depreciation. The correction of the error when discovered in the next year should be treated as

A. A prior period adjustment.

B. Other expense for the year when the error was made.

C. An increase in depreciation expense for the year when the error is discovered.

D. A component of income for the year when the error is discovered but separately reported

9. Which of the following statements in relation to a statement of changes in equity is true?

I. An entity presenting a single statement of comprehensive income shall present a statement of changes in equity.

II. An entity presenting a separate income statement and a separate statement of comprehensive income shall present a statement of changes in equity.

A. I only

B. II only

C. Both I and II

D. Neither I nor II

10. An income statement

A. summarizes the changes in retained earnings for a specific period of time.

B. reports the changes in assets, liabilities, and stockholders' equity over a period of time.

C. reports the assets, liabilities, and stockholders' equity at a specific date.

D. presents the revenues and expenses for a specific period of time.

Answer for Self Assessment

1.	B	2.	B	3.	C	4.	D	5.	C
6.	B	7.	D	8.	A	9.	C	10.	D

Review Questions

1 Name the two types of financial statements of company.

2. What do you mean by "Small medium enterprises"?

3. What is meant by "IAS 1"?

4. What are the differences between "IAS 8" and "AS 5"?

5. "Harmonization of accounting" is preferred by companies and nations—Why?

6. Enlist the objectives of IAS 1.

7. Preparing a Statement of Changes in Equity - A Business Case:
The following business case will allow you to apply your knowledge of the Statement of Changes in Equity as you take the role of an accountant in a small furniture business.

Case:

It is the month of February, and your accounting department is hard at work finalizing the financial statements. The board is demanding a draft of the financial statements in order to help them assess the company's health and performance. Your manager has decided to divide the task among the members in the accounting team and has trusted you to prepare a draft Statement of Changes in Equity for the most recent year. You are provided with the following preliminary information for the previous year's financial statements and the current year's activity:

Opening balances of all equity accounts:

Item	**$**
Share capital	500,000
Retained earnings	23,500
Accumulated Other Comprehensive Income	6,500

Preliminary financial data:

Revenue was $555,200, and expenses were $490,700 for the year.
A Cash dividend of $10,000 was declared and paid in the current year.
A retrospective change in accounting policy (i.e., change in depreciation method) resulted in an understatement of last year's income by $5,500.
The Other Comprehensive Income for the year is $6,000.

Required:

Prepare and present in good form a Statement of Changes in Equity for the year.

Solution:

Account	Share capital	Retained earnings	Accumulated Other Comprehensive Income	Total Equity
Beginning balance	500,000	23,500	6,500	530,000
Net income =555,200-490,700		64.500		64.500
Dividends		(10,000)		(10,000)
Retrospective adjustment fore policy change		5,500		5,500
Other Comprehensive Income			6,000	6,000
Ending balance	**500,000**	92,500	**12,500**	**605,000**

8. Explain the full format of statement of change in equity.

9. What do you mean by IFRS for SMEs? Define the current scenario of Ind AS 8.

Further Readings

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Unit 13: Phases of HR Predictive Modeling

CONTENTS

Objectives

- know the Phases of HR Predictive Modeling
- understand Operational Reporting

Introduction

Predictive modeling is a mathematical process used to predict future events or outcomes by analyzing patterns in a given set of input data.

It is a crucial component of predictive analytics, a type of data analytics which uses current and historical data to forecast activity, behavior and trends

Examples of predictive modeling include estimating the quality of a sales lead, the likelihood of spam or the probability someone will click a link or buy a product.

These capabilities are often baked into various business applications, so it is worth understanding the mechanics of predictive modeling to troubleshoot and improve performance.

Although predictive modeling implies a focus on forecasting the future, it can also predict outcomes (e.g., the probability a transaction is fraudulent).

In this case, the event has already happened (fraud committed).

The goal here is to predict whether future analysis will find the transaction is fraudulent.

Predictive modeling can also forecast future requirements or facilitate what-if analysis.

13.1 Top Types of Predictive Models

- **Unsupervised models** use traditional statistics to classify the data directly, using techniques like regression, time series analysis and decision trees.
- **Supervised models** use newer machine learning techniques such as neural networks to identify patterns buried in data that has already been labeled.

13.2 Models

The biggest difference between these approaches is that with supervised models more care must be taken to properly label data sets upfront.

"The application of different types of models tends to be more domain-specific than industry-specific," said Scott Buchholz, government and public services CTO and emerging technology research director at Deloitte Consulting.

- In certain cases, for example, standard statistical regression analysis may provide the best predictiv power.
- In other cases, more sophisticated models are the right approach.

For example, in a hospital, classic statistical techniques may be enough to identify key constraints for scheduling, but neural networks, a type of deep learning, may be required to optimize patient assignment to doctors.

Once data scientists gather this sample data, they must select the right model.

Linear regressions are among the simplest types of predictive models.

Linear models take two variables that are correlated -- one independent and the other dependent -- and plot one on the x-axis and one on the y-axis.

The model applies a best fit line to the resulting data points. Scientists can use this to predict future occurrences of the dependent variable.

13.3 Operational Phase

Operational reporting is a reporting procedure that details the ins and outs of a company's day-to-day deliverables, often concerning production.

Definition

Operational reporting focuses on producing detailed reports of day-to-day organizational operations. These reports include data pertaining to production costs, records, resource expenditures, in-depth examinations of processes, and even accounting.These reports come in different time intervals, but generally focus on the short-term.

Operational reports can also be modified by specific stakeholders and tailored to their needs to provide clearer insights.

The last 50 years have seen considerable changes in the delivery of human resourcesHR has developed from the traditional role of industrial relations specialists negotiating terms and conditions of work to business partners working with managers to add value to the company.

HR now delivers two distinct functions: transformational HR, delivering strategy and change, and transactional HR, dealing with administrative and operational tasks.

Operational reports provide a precisely formatted, ready-to-analyze view of an organization's operational activities such as sales performance, manufacturing productivity, or patient care efficacy.

13.4 Phases of Predictive Modeling

I. Operational Phase

II. Advanced Reporting Phase

III. Analytics

IV. Predictive Analytics

Case Study: Now that Jen's team is on board, they just need to dive deeper into the data.

They start by talking about what they each already know well.

The HRBP mentions that they routinely send out exit surveys and that employees have the option to do an exit interview.

She points out that they also have performance ratings

The organizational effectiveness specialist mentions the engagement survey.

It's only administered annually, but there may be something the team can learn from it.

The talent acquisition manager mentions that his team enters some data into the system during the recruiting and hiring process.

For example, they use rationale codes to keep track of why candidates turn down a job offer.

Salary is one of the rationales included in the codes.

Jen's team is off to a great start! Jen gives assignments to each of them to dig around and see what they have.

She also asks the compensation and benefits manager to put something together to show their salary ranges relative to the market.

She poses a question to the group: "How can we learn more?

Q:What would be more compelling to R&D managers?" The compensation and benefits manager offers a suggestion.

If the team can give her a list of everyone who's leaving the organization in the last few years, she can look up their pay history.

She can see not just where they were in the salary range, but also what other kinds of rewards they'd gotten during their tenure.

All of these data sources make Jen think that looking at turnover alone isn't enough.

The team can't just look at the employees who left.

They'd be neglecting a huge pool of information by ignoring the current employees.

Moreover, the team can't link anonymous engagement survey data with specific separations.

13.5 When to Use Operational Reporting

1. Daily, or even hourly, operational reports can help workers in fast-paced industries react to situations quickly, be proactive about improving business processes, and measure their success as situations change.
2. High-level executives might only need monthly reports to track the company's progress and assimilate broad-based performance overviews for specific departments.
3. Businesses in industries such as the financial sector, technology, retail sales, advertising, marketing, and healthcare, among others, rely on BI insights generated in operational reports and dashboards to showcase their successes, improve sales or customer satisfaction, and find better ways to execute their core competencies.
4. Operational reporting provides a structural and tactical view of an organization.
5. It details the daily aspects of operations, focusing on delivering BI insights that are immediately actionable.
6. These reports provide a detailed view of the present and immediate necessities, highlighting key areas of need.
7. In most organizations, operational reports are used as the support basis for rapid decision-making.

Lab Exercise: Think about Jen's turnover situation in R&D. (Case above mentioned)

Essentially, she wants to know if pay is causing the spike in turnover. If it isn't, what is?

Now think about the HR analytics maturity model.

Let's work through it. If Jen were addressing this question from each level of the model, what data would she need? What might she investigate? What results might she report?

13.6 Predictive Analytics in Practice

Day#	Forecast	Humidity	Play Outside
Day 1	Sunny	High	Yes
Day 2	Sunny	High	Yes
Day 3	**Cloudy**	High	Yes
Day 4	Rainy	High	No
Day 4	Rainy	Normal	No
Day 5	**Cloudy**	Normal	Yes
Day 6	Sunny	Normal	Yes

Day 7	Sunny	High	Yes
Day 8	Rainy	Normal	No
Day 9	Sunny	Normal	Yes
Day 10	Cloudy	Normal	Yes
Day 11	Cloudy	High	Yes
Day 12	Rainy	Normal	No
Day 13	Cloudy	High	Yes
Day 14	Rainy	High	No

Say there is a playground next to your house. For the past two weeks, you wrote down if there were kids playing on the playground or not. You also wrote down if it was sunny, rainy or cloudy, the temperature and the humidity. Based on the data you collected, would you be able to predict if kids will be playing on the playground on a specific day?

This is a tricky question. Obviously, these weather conditions have something to do with whether kids are playing outside or not. If the weather forecast is rainy, it will probably rain, meaning that kids are less likely to play outside. When it is hot, kids probably will play outside. But does your spreadsheet with information of fourteen consecutive days hold sufficient data to make an accurate prediction on whether or not kids will play outside?

13.7 HR predictive analytics apply in practice

- Now, how do predictive analytics apply to HR? HR possesses large quantities of people data, usually managed in a Human Resources Information System. By applying predictive analysis to this data, HR is able to become a strategic partner that relies on proven and data-driven predictive models, instead of relying on gut feeling and soft science. HR predictive analytics enable HR to forecast the impact of people policies on well-being, happiness, and bottom-line performance. An example is the role it can play in preventing expensive employee turnover.
- However, only a few organizations are capable of producing predictive models for HR. According to Deloitte's 2018 People Analytics Maturity Model, only 17% of organizations worldwide had accessible and utilized HR data. This is up from 8% in 2015, and 4% in 2014.

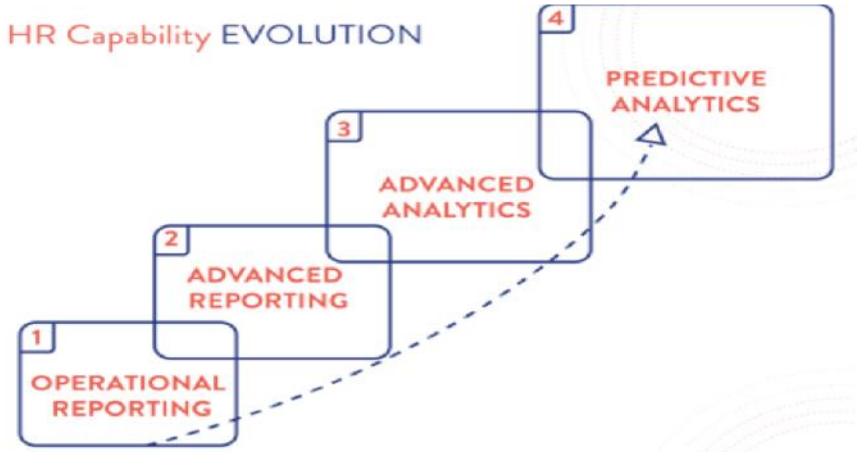

Fig 13.1 :HR capability Evolution

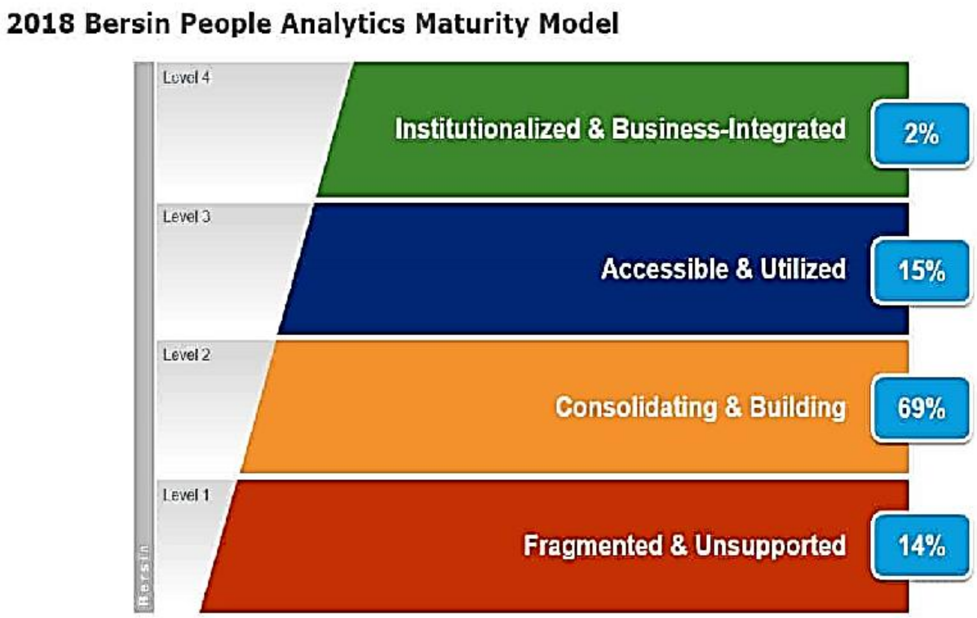

Fig 13.2: Analytics maturity Model

13.8 Advanced Reporting

Advanced reporting: is more detailed descriptive reporting that often uses the same data as operational reporting but with the addition of tracking trends or the progress towards goals. This reporting usually still reflects only the current or historical situation for various HR measures of interest. It might provide insights useful for benchmarking and decision-making and be delivered in static or interactive digital dashboards. This is also 'must-have' reporting for most organizations, so, again, it's important that the data is prepared efficiently and displayed.

Advanced Reporting and analytics to adjusters to help make an immediate impact on claim decisions, claims organizations should also be implementing advanced reporting and analytics to support their operations.

Understand Internal Claim Operations

Internal reporting and analytics can help give managers at claims organizations insight into how their claims departments are operating. Specifically, there are a few key metrics that claims organizations can track constantly at the bill review level to help them make real-time adjustments and improvements, including: bill inventory, pend aging, number of bills a specific team works per day and average time per bill. Providing managers with insight into this type of reporting can allow them to fully understand how their department is operating and influence them to make key decisions to improve business outcomes.

Analyze Trends and Compare to Industry

Advanced reporting and analytics can help a claims organization to analyze trends within its own claim data in addition to comparing that data to industry metrics. This kind of insight will support claims organizations in interpreting what is going on in their claims processes so they understand if they are overpaying or underpaying for certain treatments compared to the industry and allow them to make adjustments within their operations.

Effectively Leveraging Reporting & Analytics in Claims

In order to make investment in reporting and analytics worth a claims organization's time, it's important to focus in on deriving actionable insights that can help make a tangible difference in operations and claim outcomes. By implementing both analytics that can surface information in the claims process and internal reporting that can help managers spot operational trends and make business improvements, organizations can begin to cultivate improved return on analytics investment.

13.9 Advanced Analytics

Advanced analytics is a data analysis methodology that uses predictive modeling, machine learning algorithms, deep learning, business process automation and other statistical methods to analyze business information from a variety of data sources.

Meaning

- Advanced analytics uses data science beyond traditional business intelligence (BI) methods to predict patterns and estimate the likelihood of future events. This in turn can help an organization be more responsive and significantly increase its accuracy in decision-making.
- Often used by data scientists, advanced analytics tools both combine and extend prescriptive analytics and predictive analytics while adding various options for enhanced visualization and predictive models.
- ***Deep learning***: Deep learning is a type of machine learning and artificial intelligence (AI) that imitates the way humans gain certain types of knowledge.
- Deep learning is an important element of data science, which includes statistics and predictive modeling.
- It is extremely beneficial to data scientists who are tasked with collecting, analyzing and interpreting large amounts of data; deep learning makes this process faster and easier.
- At its simplest, deep learning can be thought of as a way to automate predictive analytics. While traditional machine learning algorithms are linear, deep learning algorithms are stacked in a hierarchy of increasing complexity and abstraction.
- Computer programs that use deep learning go through much the same process as the toddler learning to identify the dog.
- Each algorithm in the hierarchy applies a nonlinear transformation to its input and uses what it learns to create a statistical model as output. Iterations continue until the output has reached an acceptable level of accuracy.
- The number of processing layers through which data must pass is what inspired the label deep
- To understand deep learning, imagine a toddler whose first word is dog. The toddler learns what a dog is -- and is not -- by pointing to objects and saying the word dog. The parent says, "Yes, that is a dog," or, "No, that is not a dog."
- As the toddler continues to point to objects, he becomes more aware of the features that all dogs possess. What the toddler does, without knowing it, is clarify a complex abstraction -- the concept of dog -- by building a hierarchy in which each level of abstraction is created with knowledge that was gained from the preceding layer of the hierarchy.

Deep Learning and Model building

- Initially, the computer program might be provided with training data -- a set of images for which a human has labeled each image dog or not dog with metatags. The program uses the information it receives from the training data to create a feature set for dog and build a predictive model.
- In this case, the model the computer first creates might predict that anything in an image that has four legs and a tail should be labeled dog.

- Of course, the program is not aware of the labels four legs or tail. It will simply look for patterns of pixels in the digital data. With each iteration, the predictive model becomes more complex and more accurate.

13.10 Why is Advanced Analytics Important?

- Advanced analytics is a valuable resource to enterprises because it enables an organization to get greater functionality from its data assets, regardless of where the data is stored or what format it's in. Advanced analytics also can help address some of the more complex business problems that traditional BI reporting cannot.

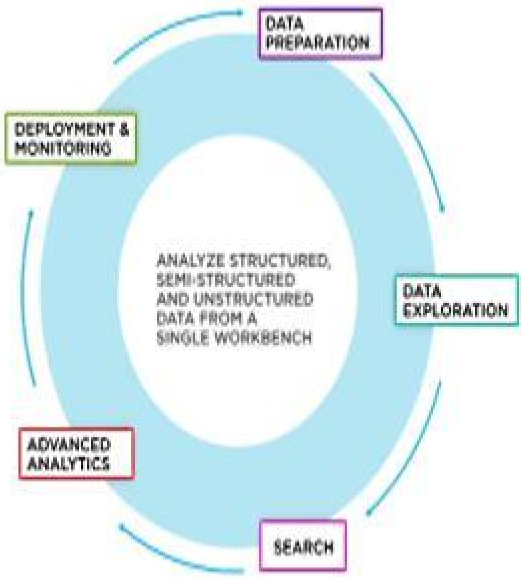

Fig 13.3 Advanced Analytics

For example, to create a contextual marketing engine, a consumer packaged goods manufacturer might need to ask the following questions:

- When is a customer likely to exhaust their supply of an item?
- What time of the day or week are they most receptive to marketing advertisements?
- What level of profitability is achievable when marketing at that time?
- What price point are they most likely to purchase at?

13.11 Benefits of Advanced Analytics

- In addition to enabling greater use of data assets and providing decision-makers with greater confidence in data accuracy, advanced analytics offers the following benefits:
- **Accurate forecasting**. Using advanced analytics can confirm or refute prediction and forecast models with a greater level of accuracy than traditional BI tools that still carry an element of uncertainty.
- **Faster decision-making**. With predictions that feature a high level of accuracy, executives can act more quickly, confident their business decisions will achieve the desired results and that favorable outcomes can be repeated.
- **Deeper insight**. Advanced analytics offers a deeper level of actionable insight from data, including customer preference, market trends and key business processes, which

empowers stakeholders to make data-driven decisions that can directly affect their strategy.

13.12 Advanced Analytics Techniques

Advanced analytics can help provide organizations with a competitive advantage. Some commonly used advanced analytics techniques include the following:

Data mining. This process sorts through large data sets to identify patterns and establish relationships to solve problems through data analysis.

Sentiment analysis. This technique uses natural language processing, text analysis and biometrics to identify the emotional tone behind a body of text.

Cluster analysis. This process matches pieces of unstructured data based on similarities found between them.

- **Predictive Analytics**: Data analytics used to make predictions concerning future business outcomes, based upon historical data and using statistical modeling (regression models) and machine learning (ML) techniques.
- C**alculatio**ns: Different calculation tools like aggregations on visualizations, expressions, and more can be used in advanced analytics.
- **Statistical Features**: It's important to have statistical features in order to perform advanced analytics, including clustering, box plots, comparison circles, and relationships between categorical variables (Chi-square).
- **Machine learning**: Machine learning algorithms learn from the data to produce detailed models that can identify complex patterns and make highly accurate predictions. They are well suited to use cases such as micro-segmentation, personalization, root cause analysis of complex processes, fraud detection, and customer churn
- **Complex event processing**. This technique uses technology to predict high-level events likely to result from specific sets of low-level factors.
- **Big data analytics.** This is the process of examining large volumes of structured, semi-structured and unstructured data to uncover information such as hidden patterns, correlations, market trends and customer preferences.
- **Machine learning**. The development of machine learning has dramatically increased the speed at which data can be processed and analyzed, facilitating disciplines like predictive analytics.
- **Data visualization**. This process of presenting data in graphical format makes data analysis and sharing more accessible across organizations.
- ***Open source tools***
- Opensource tools have become a go-to option for many data scientists doing machine learning and prescriptive analytics. They include programming languages, as well as computing environments, including Hadoop and Spark. Users typically say they like open source advanced analytics tools because they are generally inexpensive to operate, offer strong functionality and are backed by a user community that continually innovates the tools.
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- Proprietary tools

On the proprietary side, vendors including Microsoft, IBM and SAS Institute all offer advanced analytics tools. Most have required a deep technical background and understanding of mathematical techniques.

In recent years, however, a crop of self-service analytics tools has matured to make functionality more accessible to business users. Tableau, in particular, has become a common tool. While its functionality is more limited than deeper technical tools, it does enable users to conduct cluster analyses and other advanced analyses.

Case Study: Liberty Mutual Insurance Investigates Turnover

A department with high-volume positions was experiencing elevated turnover at Liberty Mutual Insurance and sought help. Leaders turned to the talent analytics department to understand

Why employees were leaving?

To predict future turnover rates

Although it was important to predict how many hires would be required to replace separations, the primary goal was to identify actionable drivers of turnover and take action to reduce turnover going forward.

Talent analytics gathered data from a variety of sources. They talked to stakeholders and studied exit interviews to identify key variables. Once they gathered the data, they developed turnover models to understand which variables were most predictive of voluntary turnover.

One of the variables found to be associated with increased turnover was applying for positions within the company. These data were gathered from the internal ATS.

The ATS is a rich data source that includes variables such as where in the company the employee applied, the outcome of the application (hired or declined), and what stage(s) of the interview process the employee completed.

A series of descriptive analyses and t-tests were performed to investigate the internal application issue. By comparing the quarterly turnover rates for those who applied for other jobs within the company and those who did not, Liberty Mutual confirmed that internal job searching was associated with an increased risk of turnover.

Further, by comparing the turnover rates of successful and unsuccessful internal applicants to other employees,

Liberty Mutual discovered that unsuccessfully applying for internal positions was uniquely associated with subsequent voluntary turnover: those who applied from within and were rejected turned over at approximately twice the rate of other employees.

Those rejected before receiving a phone screening were especially at risk, while employees who completed a phone screening before the rejection had turnover rates similar to employees who did not participate in any internal job searches.

Additional analyses revealed that the pattern persisted for employees whose performance met or exceeded expectations.

Talent analytics developed a hypothesis that phone screening all internal applicants could provide employees with critical feedback for career development and soften the blow of rejection. Talent analytics used this information to connect with the talent acquisition and the talent management departments to better understand the rejection process as well as what could be done to improve the employee experience.

A cost-benefit analysis revealed that Liberty Mutual could phone screen all internal applicants with only a modest increase in the number of full-time recruiters.

Given the high cost of turnover, the additional costs associated with recruiter salary would still result in cost savings for the company.

Summary

Data-driven decisions are more accurate than those made based on intuition alone. Using predictive analytics to make better decisions allows businesses to save money, increase productivity, and improve customer satisfaction.

Keywords

Operational reporting, Advanced Reporting, Open source, Predictive analytics

Self Assessment

1.Cost benefit analysis in any company can be achieved via

A. Data analytics
B. Advanced analytics
C. Big data
D. HR analytics

2. With huge amounts of data being generated every day, businesses are looking for new ways to take advantage of all that data by utilizing

A. Advanced analytics
B. HR Analytics
C. People analytics
D. Data analytics

3. Open source tools have become a go-to option for many data scientists doing machine learning and ____________

A. Prescriptive analytics.
B. Predictive
C. Descriptive
D. Data analytics

4.. The process of presenting data in graphical format makes data analysis and sharing more accessible across organizations.

A. Data visualization
B. Data analysis
C. Data presentation
D. None of the above

5. Operational reporting

A. focuses on producing detailed reports of day-to-day organizational operations.
B. Using advanced analytics can confirm or refute prediction and forecast models with a greater level of accuracy than traditional BI tools that still carry an element of uncertainty
C. Using advanced analytics can confirm or refute prediction and forecast models with a greater level of reliability.

D. Using advanced analytics can confirm or predict and forecast models with a greater level of accuracy

6.____________use traditional statistics to classify the data directly, using techniques like logistic regression, time series analysis and decision trees

A. Supervised Models
B. Analytical model
C. Unsupervised Models
D. Predictive model

7.______________use newer machine learning techniques such as neural networks to identify patterns buried in data that has already been labeled.

A. Unsupervised Models
B. Supervised models
C. Operational Risk
D. Not Applicable

8. This process matches pieces of unstructured data based on similarities found between them.

A. Pattern analysis
B. Cluster analysis.
C. Descriptive analysis
D. Exploratory analysis

9. Advanced analytics tools both combine and extend

A. prescriptive analytics and
B. predictive analytics
C. Both A& B
D. None of above

10.This technique uses natural language processing, text analysis and biometrics to identify the emotional tone behind a body of text.

A. Descriptive analysis
B. Sentiment analysis
C. Content analysis
D. Thematic analysis.

11.Operational reporting

A. focuses on producing detailed reports of day-to-day organizational operations
B. focuses on producing detailed reports of organizational operations
C. focuses on producing employees reports
D. focuses on producing detailed reports of anually organizational operations

12. Data analytics used to make predictions concerning future business outcomes, based upon historical data and using statistical modeling (regression models) and machine learning (ML) techniques.

A. True

B. False

13. Cluster analysis is the process matches pieces of unstructured data based on similarities found between them

A. True

B. False

14.Predictive analytics is all about

A. Predicting sales

B. Predicting turnover

C. Predicting revenue

D. All of above

15.Once data scientists gather this sample data, they must select the ______

A. right model.

B. Right tool

C. Right technique

D. Right approach

Answers for Self Assessment

1.	B	2.	A	3.	A	4.	A	5.	A
6.	C	7.	B	8.	B	9.	C	10.	B
11.	A	12.	A	13.	A	14.	D	15.	A

Review Questions

Q1. How does predictive analytics work in a HR consultancy?

Q2. What are the benefits of predictive analytics?

Q3. Discuss some situation in the organization where operational reporting is required.

Q4. List out the methods of advanced reporting techniques.

Q5. Write a note on predictive modelling.

Further Readings

1. Intro to HR Metrics and Workforce Analytics 29 Pages · 2017 · 2.87 MB · 3,572 Downloads · English by Jeremy A. Mendoza
2. The New HR analytics by Jacfitzenz(Predicting the economic value of

capital investment)

Web Links

https://forms.workday.com/content/dam/web/en-us/documents/ebooks/workforce-reporting-analytics-ebook-enus%20(1).pdf

https://www.oracle.com/a/ocom/docs/hr-analytics-report-ipaper.pdf

https://www.aihr.com/resources/The_Basic_principles_of_People_Analytics.pdf

Unit 14:Accounts of Banking Companies

CONTENTS

Objectives

After studying this subject, you will be able to comprehend:

- Define holding company and subsidiarycompany.
- Understand the legal requirements relatingto presentation of accounts by a holdingcompany.
- Understand the requirements of Schedule VI.
- Explain Consolidated financial statements.

Introduction

Accounting procedure for banking companies differs from those of other joint stock companies. Despite the fact that banking companies are incorporated under the Companies Act, 1956, they have to strictly comply with the provisions of The Banking Regulations Act, 1949. In addition, the banking companies will have to adhere to the norms and guidelines issued by the Reserve Bank of India (RBI Act 1934). One has to understand all the important statutory provisions of these acts in order to prepare final accounts of banking companies.

14.1 Definition and Meaning of Bank, Banking And Banking Company

Bank: In its broadest sense, the term "bank" is used to refer any institution, which is engaged in carryingon certain kinds of financial business. It may be defined as follows: "A bank is an organization that holdsmoney, important documents and other valuables in safe keeping and the money being paid out on the customer's order/request." A bank deals with money. It acts in the same way as a trader buys and sells goodsat a profit. It is involved in financial trading activities.

Banking: The Banking Regulation Act, 1949 [Section 5(b)] defi nes banking as, "accepting for the purposeof lending or investment, of deposits of money from the public, repayable on demand or otherwise, andwithdrawals by cheque, draft or otherwise".

Banking company: As per Section 5(c) of the Banking Regulation Act, banking company means anycompany, which transacts the business of banking in India.

14.2 Forms of Business of Banking Companies

According to Section 6 of the Banking Regulation Act, a bank, in addition to banking business, may indulge in the forms of business, which are listed as follows:

(i) Borrowing, raising or taking up money.

(ii) Lending or advancing money.

(iii) Drawing, making, accepting, discounting, buying, selling, collecting and dealing with bills of exchange, hundis, promissory notes and other instruments.

(iv) Granting and issuing of letters of credit, travellers' cheques and circular notes.

(v) Buying, selling and dealing with bullion.

(vi) Buying and selling, on commission, and underwriting and dealing with stock, shares, debentures, bonds, etc.

(vii) Receiving all kinds of scripts or valuables on deposit for safe custody.

(viii) Providing safe deposit vaults.

(ix) Collecting and transmitting money and securities.

(x) Carrying on and transacting every kind of guarantee and indemnity business.

(xi) Undertaking and executing trusts.

(xii) Undertaking the administration of estates as executor, trustee or otherwise.

(xiii) Contracting for public and private loans and negotiating and issuing the same.

(xiv) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into accounts or otherwise dealing with all or any part of the property and rights of the company.

(xv) Doing all such things, which are incidental or conductive to the promotion or advancement of the business of the company.

(xvi) Any other form of business, which the Central Government may, by notification in the "Official Gazette", specify as a form of business in which it is for a banking company to engage.

(xvii) Acquiring and undertaking the whole or any part of the business of any person or a company when such business is of a nature enumerated or described in this sub-section.

No banking company shall engage in any form of business other than those mentioned above, as per Section 6(2) of the Banking Regulation Act, 1949.

14.3 Classification of Commercial Banks

Commercial banks are classified into two: (1) scheduled banks and (2) other banks.

Scheduled bank: A scheduled bank is one which is included in the second schedule of Reserve Bank of India Act, 1934. A scheduled bank should comply with the following terms:

(i) It must have paid-up capital and reserves as specified in the table below.

(ii) The activities to be carried out should not be detrimental to the interests of the depositors.

(iii) It should be incorporated under the Companies Act, 1956, that is, it should not be the sole trader for a partnership fi rm of business organization.

14.4 Important Legal Provisions of Banking Regulation Act 1949

Important legal provisions of Banking Regulation Act, 1949 are as follows:

1. Trading restrictions: As per Section 8, a banking company cannot directly or indirectly deal with the business of buying or selling or bartering of goods, except in connection with the realization of security given to or held by it or engage in any trade or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or for the administration of estates as executor, trustee or otherwise.

2. Non-banking assets: In case of a failure of a debtor to repay the loan within the stipulated period, the bank can take possession of such assets mortgaged. As per Section 9, a banking company cannot hold any immovable property, however acquired, except for its own use, for any period exceeding 7 years from the date of acquisition there of. The gain or loss on the sale of such assets should be shown in the P & L A/c of the banking company separately.

3. Authorized capital, subscribed capital and paid-up capital:

As per Section 12,

(i) The subscribed capital of a banking company must not be less than half (50%) of its authorized capital.

(ii) Its paid-up capital must not be less than half (50%) of its subscribed capital.

(iii) The share capital of a banking company should comprise of only equity or ordinary shares and such preference shares, which have been issued prior to 1 July 1944.

(iv) The voting right of a shareholder on poll in respect of any shares held by him is limited to 10% of the total voting rights of all the shareholders of the company (w.e.f. 31 January 1994).

4. Payment of commission, brokerage, etc.:

According to Section 13, a banking company cannot pay out directly or indirectly any commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, exceeding 2½% of the paid-up value of the shares.

5. Charge on uncalled capital: As per Section 14, a banking company cannot create any charge on unpaid capital. Any such charge is null and void. According Section 14A, a banking company cannot create a floating charge on the undertaking or any property of the bank except with the written permission of the RBI certifying that the charge will not be detrimental to the interest of the depositors.

6. Payment of dividend: According to Section 15, a banking company cannot make payment of dividend until all of its capitalized expenses are completely written off. Payment of dividend out of profits is not proper when capitalized expenses are outstanding. Preliminary expenses, organization expenses, share-selling commission, brokerage, amounts of losses incurred and any expenditure not represented by tangible assets are examples for capitalized expenses.

A banking company, however, may pay dividends on its shares without writing off the following:

(i) Depreciation in the value of its investments in approved securities where such depreciation has not been actually capitalized or otherwise accounted for as loss.

(ii) Depreciation in the value of its investment in other than approved securities where adequate provision has been made to the satisfaction of the auditors of the company.

(iii) Bad debts, if any, where adequate provision has been made.

7. Statutory reserve fund: According to Section 17, every banking company incorporated in India should create a reserve fund and transfer at least 20% of its profit to such reserve funds before any dividend is declared.

According to RBI direction, every bank has to transfer 25% of the net profits to statutory reserve.

8. Cash reserves: Under Section 18, every non-scheduled bank shall maintain a cash reserve with itself or with RBI, a sum equivalent to at least 3% of its total time and demand liabilities in India on the last Friday of the second preceding fortnight and shall submit to the RBI before 20th day of every month a return showing the amount so held on alternate Fridays during a month with particulars of its demand and time liabilities in India on such Fridays or if any such Friday is a public holiday, at the close of the business on the preceding working day. From June 1994, banks are required to maintain with RBI a uniform average daily balance (cash reserve) of 15% of their entire net demand and time liabilities.

It is important to note that from 22 June 2006 the RBI can prescribe the cash reserve ratio (CRR) for scheduled commercial banks without any ceiling rate. Hence, the statutory minimum CRR of 3% of the total demand and time liabilities no longer exist. At present CRR is 6% w.e.f. December 2010.

9. Liquidity requirements: As per the amendment envisaged to Section 24 by the Banking Regulation (Amendment) Act, 2007, effective from 2007, the RBI can prescribe the statutory liquidity ratio (SLR) for scheduled commercial banks in specified assets. The value of such assets of a scheduled commercial bank shall not be less than such a percentage not exceeding 40% of its total demand and time liabilities.

The RBI can specify this norm from time to time. At present, the norm for SLR as per RBI is 24% from December 2010.

Any banking company, scheduled or non-scheduled, is required to maintain cash, gold or unencumbered approved securities, which is not less than 25% of the total of its time and demand liabilities in India. This is also referred to "statutory liquidity ratio" (SLR).

Prescribed form: Under Sections 29–33 of the Banking Regulation Act, every banking company is required to prepare a balance sheet in accordance with Form A set out in the Third Schedule of the said Act and a P & L A/c in conformity with Form 15 of the same schedule. The formats have been revised with effect from 1 April 1991.

Accounting year: A banking company has to close its account on 31 March every year, i.e. the accounting year commences on 1 April and closes on 31 March next year.

Loans and advances: There are certain restrictions on the loans granted by banks to persons associated with their management. As per Section 20, the restrictions are as follows:

1. A banking company cannot grant loans and advances on the security of its own shares.

2. It should not grant any loan or advance to:

(i) Any of its directors.

(ii) A firm in which any of its directors is interested as a partner, manager, or employee.

(iii) Any company of which any of the directors of the banking company is a director, manager or guarantor.

(iv) Any individual with whom any of its directors is a partner or a guarantor.

14.5 Bank Balance Sheet vs Company Balance Sheet

Difference Between Bank Balance Sheet and Company Balance Sheet

A bank balance sheet preparation is complicated since the banking institutions will need to calculate their net loans, which is time-consuming. The items recorded in this balance sheet are loans, allowances, Short Term Loan etc. In contrast, preparing a company's balance sheet is not that complicated and time-taking, and it records items like assets, liabilities, and net worth. Before we go into the nitty-gritty of the bank's balance sheet and any regular company, first, we need to look into the nature of each.

The bank acts as an intermediary between two parties. The job of a bank is to assist the company in which it can help. Bank makes profits from the spread between the rate it receives and pays.

On the other hand, a company operates to produce goods or services and ultimately sells these goods or services to another business, end customer, or Government. Running a regular company aims to generate and maximize wealth for its shareholders.

As the nature of both of these entities is different, it makes sense to prepare a unique balance sheet for each of them.

The differences between Bank Balance Sheet vs. Company Balance Sheet are as follows:

Basis for Comparison	Balance Sheet of Bank	Balance Sheet of a Regular Company
1. Definition	Bank's balance sheet is prepared as per the mandate by the Regulatory Authorities	The company's balance sheet is prepared as per the regulation of the International Accounting Standards Board (IASB).
2. Objective	The main objective is to showcase an accurate trade-off between bank's profit and risk.	The main objective is to reflect the accurate financial picture of an organization to the stakeholders.
3. Scope	The scope of the bank's balance sheet is limited since it's applicable only for banks.	The scope of the company balance sheet is the much broader sense it is applicable to all sorts of companies (manufacturing, auto, etc.).
4. Equation	Assets = Liabilities + Shareholders' Equity	4. Equation – Bank Balance Sheet vs. Company Balance Sheet
5. Complexity	The preparation of a balance sheet for a bank is quite complex since the bank needs to calculate the "net loans."	The preparation of the company balance sheet is much simpler.
6. Time consumption	Bank's balance sheet needs a lot of time to prepare.	The company's balance sheet doesn't take a lot of time to prepare.
7. Key concepts	Loans, Short-term investments, Provision for losses on loans;	Assets, Liabilities, & Shareholders' Equity.
8. Mentionable document	Bank balance sheet mentions reference through "schedules."	The company balance sheet mentions its reference via "notes."
9. Type of balance	In the bank balance sheet, the type of balance is the average balance.	In the company balance sheet, the type of balance is ending balance.

The differences between Bank Balance Sheet vs. Company Balance Sheet are as follows:

1. The bank's balance sheet is quite different from the Balance Sheet of a Regular Company in the approach of preparation. Both are prepared quite differently.
2. The assets and liabilities of a bank are much different from a regular company's assets and liabilities. That's why even if the arrangement of the bank and a regular company is similar, the items are always different.
3. In the banks' balance sheet, the average balances are summed up and recorded. It gives a better framework for the financial performance of the banks. On the other hand, the balance sheet of a regular company takes the ending balance from the trial balance. Trial balance is prepared from the ledger accounts. And then, from trail balance, the ending balance is transferred to the balance sheet of a regular company.
4. To show new information, the bank's balance used "schedules." On the other hand, to show new information, a balance sheet of a regular company uses "notes."
5. To prepare a balance sheet for a bank, an accountant has to go through a lot of information. S/he needs to look through the short-term investments of the banks, the loans (personal & mortgage), deposits, interest paid & received, etc. That's why preparing the balance sheet of a bank is quite cumbersome. On the other hand, preparing the balance sheet of a regular company is pretty easy. All you need to do is find out current assets,

fixed assets, current liabilities, non-current liabilities, and shareholders' equity. And you would be able to prepare the balance sheet easily.

6. Banks take more risks than any other company. That's why in the bank's balance sheet, a separate provision (allowance) is created to cover the losses on loans. There Are provisions for bad debts or creditors in the balance sheet of a regular company, but they are not similar to allowance created in the bank's balance sheet.
7. Many economic factors affect the balance sheet of a bank. But in the case of a regular company, rarely external events affect the preparation of the balance sheet.

Structure of Bank's Balance Sheet

Bank Balance Sheet is prepared differently from the Company Balance Sheet. The first few items on the Balance Sheet of a Bank are similar to the Balance Sheet of a Regular Company. For example, cash, securities, etc., come under assets on the Bank's Balance Sheet.

Schedules in a Bank Balance Sheet

Schedules are mentioned in a Bank Balance Sheet because schedules refer to additional information. Key schedules that are being used in the bank balance sheets are –

- Deposits
- Borrowings
- Capital
- Reserves & Surpluses
- Cash on hand
- Investments
- Liabilities

Average balance

One of the unique characteristics of the bank balance sheet is that all the balances that take place on the balance sheet are average amounts. Therefore, taking average amounts provides a better idea about the financial affairs of the bank.

However, what separates the bank from the other regular company is that the bank takes more risk than any regular company.

Loans

This is one of the ways banks earn money. Banks provide loans to various customer segments. Two of the basic loans bank offers are personal loans and mortgage loans. Personal loans are given with an interest rate and without any mortgage. Usually, the interest rate remains higher in personal loans.

Mortgage loans are given against a mortgage. As the loans are offered against a mortgage, the interest rate is usually lower. But if the individual cannot pay off the loans, the mortgage is claimed by the bank.

Banks also create an allowance in the balance sheet to cover losses from the loans (if any) and change the structure of this allowance depending on the economic factors going on in the market.

Short term investments

To the banks, short term investments are also of utter importance. That's they include cash, securities under short term investments. These short-term investments do three things –

- First, short term investments lower the duration of total assets.
- Second, short term investments also lower the chances of loan default risk.
- And lastly, short term investments also increase liquidity.

Format and example of Balance Sheet of Bank

ABC Bank Balance Sheet

Particulars	Schedule	Amount (in US $, millions)
Assets		
Cash balances	8	30,000
Residential mortgage		25,000
Federal funds sold & securities purchased		11,000
Commercial		23,000
Investments	7	43,000
Credit Card		3500
Advances	6	12,500
Commercial Loans		2,000
Leases		4,500
Accumulated Depreciation	5	500
Allowance for loan & leases losses	4	7,000
Total Assets		**162,000**
Liabilities		
Savings		45,000
Time Deposits		34,000
Money Market Deposits		26,000
Federal funds sold and purchased under agreement to repurchase		5,500
Interest bearing long term debt	3	13,000
Non-interest bearing liabilities	2	3,500
Shareholders' Equity	1	35,000
Total liabilities & shareholders' equity		**162,000**

Structure of the Company's Balance Sheet

The balance sheet of a regular company is similar to a simple balance sheet format.

The balance sheet of a regular company will balance two sides – assets and liabilities.

For example, if a company takes a loan from a bank of $50,000, the transaction will take place on the balance sheet in the following manner –

Firstly, on the "asset" side, we will include "Cash" of $50,000.

Secondly, on the "liability" side, we will include "Debt" of $50,000.

For one transaction, there are two consequences, and the balance sheet balances these two.

Let's now understand "assets" and "liabilities."

Assets:

Under "assets," first, we will talk about "current assets." Current assets are assets that can be liquidated quickly in cash. Here are the items that come under current assets –

- Cash & Cash Equivalents
- Short-term investments
- Inventories
- Trade & Other Receivables
- Prepayments & Accrued Income
- Derivative Assets
- Current Income Tax Assets
- Assets Held for Sale
- Foreign Currency
- Prepaid Expenses

Here's an example for you –

	A (in US $)	**B (in US $)**
Cash	4500	5600
Cash Equivalent	6500	3400
Accounts Receivable	7000	8000
Inventories	8000	7000
Total Current Assets	26,000	24,000

Now, let's talk about "non-current assets."

Non-current assets

are also called fixed assets. They will pay you off for more than one year, and they can't easily be liquidated.

Under "non-current assets," we would include the following items –

- Property, plant, and equipment
- Goodwill
- Intangible assets
- Investments in associates & joint ventures
- Financial assets
- Employee benefits assets
- Deferred tax assets

If we add both current and noncurrent assets, we will get the total assets of a regular company.

Liabilities

In Liabilities also, we will start with “current liabilities.”

Current liabilities are liabilities that can be paid in a very short duration. Here are the items that we would include under current liabilities –

- Financial Debt (Short term)
- Trade & Other Payables
- Provisions
- Accruals & Deferred Income
- Current Income Tax Liabilities
- Derivative Liabilities
- Accounts Payable
- Sales Taxes Payable
- Interests Payable
- Short Term Loan
- Current maturities of long term debt
- Customer deposits in advance
- Liabilities directly associated with assets held for sale

Now we will look at an example of current liabilities

	M (in US $)	**N (in US $)**
Accounts Payable	21000	31600
Current Taxes Payable	17000	11400
Current Long-term Liabilities	8000	12000
Total Current Liabilities	46000	55000

We will now have a look at the “non-current liabilities.” These liabilities are long term liabilities , which the company will pay off within a long period of time.

In “non-current liabilities,” we will include the following –

- Financial Debt (Long term)
- Provisions
- Employee Benefits Liabilities
- Deferred Tax Liabilities
- Other Payables

By adding the “current liabilities” and “non-current liabilities,” we will get “total liabilities.”

To complete the balance sheet of a regular company, we have only one thing left. And that is “shareholders’ equity.”

Shareholders’ Equity

Shareholders’equity is the statement that includes that share capital and all other related adjustments. Here’s a format of shareholders’ equity –

Shareholders' Equity	
Paid-in Capital:	
Common Stock	***
Preferred Stock	***
Additional Paid-up Capital	
Common Stock	**
Preferred Stock	**
Retained Earnings	
(-) Treasury Shares	(**)
(-) Translation Reserve	(**)

If we add total liabilities and shareholders' equity, we will get a number that should match the total assets.

Now we will look at the format and example of the balance sheet of a regular company.

Format & example of the balance sheet of a regular company

Balance Sheet of ABC Company

	2016 (In US $)	**2015 (In US $)**
Assets:		
Current Assets	250,000	550,000
Investments	36,00,000	39,50,000
Plant & Machinery	22,00,000	15,60,000
Intangible Assets	35,000	25,000
Total Assets	**60,85,000**	**60,85,000**
Liabilities:		
Current Liabilities	175,000	210,000
Long term Liabilities	85,000	175,000
Total Liabilities	**260,000**	**385,000**
Stockholders' Equity		
Preferred Stock	450,000	450,000
Common Stock	49,95,000	50,00,000
Retained Earnings	380,000	250,000

Total Stockholders' Equity	**58,25,000**	**57,00,000**
Total liabilities & Stockholders' Equity	**60,85,000**	**60,85,000**

14.6 Prudential and Provisioning Norms Adopted by Banks

Traditionally, banks all over the world used to book income from loans and advances on 'Accrual Basis' and not on cash basis. The banks were charging interest on loan accounts periodically and booked the amount as earnings, irrespective of the fact whether the amount was paid by the borrower or not. Even after the borrowal account became an impaired asset, the banks kept on charging interest till a decision was taken by the authorities to cease the same.

Classification of irregular or sticky accounts was done on subjective consideration, rather than any objective criteria. The norms for provisioning for bad debts were also not well defined. As a result, it was difficult to assess the actual strength of a banking organisation, from analyses of its Balance Sheet and Profit and Loss account. In the absence of the appropriate norms for disclosure and corporate governance, the Balance Sheet of the commercial banks would conceal issues that otherwise could have shaken the confidence of the depositors and other business community at large.

During the early nineties, commercial banks all over adopted the prudential norms for income recognition, asset classification and provisioning. Accordingly, it was accepted by the banking community that an income of interest charged in a borrowal account shall be recognised only on the basis of its record of recovery or on actual payment by the borrower.

Thus, an objective policy of income recognition based on record of recovery was adopted by the banks. Likewise, the classification of assets of banks was to be made on the basis of objective criteria which would ensure a uniform and consistent application of the norms. Also the provisioning for bad loan would be based on the classification of assets and the length of the period for which the asset has stopped earning for the bank.

Prudential Norms:

A loan asset of a bank is considered as a Standard Asset as long as the borrower is paying the interest, instalments and other charges as and when debited to his account. A period of 30 days is generally allowed to the borrower to make such payments to the bank. In case the borrower fails to pay or service the account within 30 days from the data of charging, the borrowal account is termed as Irregular/Out of Order.

An account remaining irregular continuously for 90 days is classified as Sub-standard/Non-Performing Asset (NPA). Thus, in line with the international practices on prudential norms for banks, an asset is defined as non-performing when it ceases to generate income for the bank. Availability of security is never a criterion for deciding whether a loan asset is performing or non-performing.

Thus, Non-Performing Asset (NPA) is a loan or advance where:

(i) Interest and/or installment of principal remaining overdue for a period of more than 90 days in respect of a Term Loan;

(ii) The bill remains overdue for a period of more than 90 days in case of bills purchased and discounted;

(iii) When an advance is disbursed in the form of overdraft/cash credit and the account remains out of order for more than 90 days. An overdraft/ cash credit account is considered to be out of order when the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

The account shall also be treated as out of order if there is no credit in the account continuously for a period of 90 days or more or the credits are not enough to cover the interest debited during the period of last 90 days. Non-submission of inventory and receivable statements for 90 days for computation of drawing power will also render the account out of order.

In terms of the prudential norms, an overdue amount means any amount due to the bank under any credit facility, which is not paid by the borrower on the due date fixed by the bank. Further, any amount to be received for use of credit cards, debits in suspense account, etc., from a customer and if it remains overdue for a period of more than 90 days, the same is also to be treated as NPA.

Ideally, a bank should have all its assets performing all the time and there should not be any non-performing asset. But it is extremely difficult to maintain a zero-NPA level. Like any other business activity, the banking business also witnesses a certain percentage of NPA in its asset (Credit) portfolio. However, the banks always endeavour to keep the NPA level to zero or the bare minimum. This is done by a structured NPA management in the bank.

NPA Management:

Immediately after an asset becomes non-performing it is classified as Substandard and thereafter, based on the length of the period of NPA and realisable value of security, the asset is further downgraded as doubtful or loss. Absence of any realisable value of the security offered by the borrower will straight away render the asset as a Loss Asset.

It is not necessary that every NPA should pass through all the stages like Sub-standard and doubtful, before becoming a Loss Asset. If erosion in value of the security is more than 90% of amount outstanding in the loan account, the account should directly be classified as Loss Asset.

The NPA management function comprises:

(i) Prevention of slippage;

(ii) Up-gradation of the asset after its slippage; and

(iii) Initiation of recovery process which culminates into actual recovery.

Management of NPA begins with Prevention of Slippage of a borrowal account and keeping the Asset in standard category continuously. This can be done with adequate and uninterrupted monitoring of the loan accounts and recovery of interest and instalments as and when they fall due.

Avoiding large scale slippages is very important for management of NPA. In order to meet this objective, the bank should have a sound credit appraisal system in place. There should be personnel in the credit department with proper skills and expertise for credit appraisal. Proper scrutiny of the borrower and his business at the entry level plays a very important role in preventing slippage later.

Periodical review of the account should be done with utmost seriousness. Credit monitoring should be effective at pre-disbursement, during disbursement, and post-disbursement stages. Early warning signals need to be identified in time and necessary corrective steps are to be initiated without loss of time. The task of restructuring/re-phasing of payables by the borrower is to be undertaken before the accounts slip into NPA category, provided the activities of the borrowing unit is considered economically viable.

When the slippage cannot be prevented and the borrowal account slips to NPA category, efforts should be made to recover the dues, if necessary, by restructuring/re-phasing, as soon as possible and upgrade the account to standard category in conformity with the prescribed norms.

Up-gradation of sub-standard or doubtful account will reduce the quantum of NPA immediately and the asset starts performing or generating income once again. Sometimes, the banks prepare a rehabilitation package in an NPA account, where the business activity has become sick, but remain economically viable.

If the viability of the business activity of the unit can be established beyond doubt, the banks can devise a package whereby the existing dues of the borrowing unit are restructured or re-phased for repayment over a longer period of time, with a moratorium at the beginning.

As per the package, banks also disburse additional loans or take further exposure on the borrowing unit. The scheme may even entail giving several concessions in the rate of interest and other charges and even waiver of some interest charged in the past. This package is generally known as Rehabilitation Package.

Where a loan asset is impaired beyond control and there is hardly any scope for up-gradation, it is marked for initiation of recovery action. The bank has to recall the advance and demand repayment of the outstanding dues from the borrower. If the borrower fails to come up with the repayment, the bank has to take necessary action, either for filing of suit or recovery of the dues by disposing of the securities as per provisions of the law in the country.

Many a time, instead of filing suit for recovery of the dues, which is time consuming with attendant costs, the banks prefer a compromise settlement with the defaulting borrower, resulting into savings in recovery expenses. Even after filing of the suit, the bank and the borrower may opt for an out of the court settlement and file for a consent decree from the court.

In a situation when there is no realisable value of security and the borrower and/ or guarantor have neither any income nor any personal property to be attached by the bank, there will be no other option but to write off the outstanding.

RBI Guidelines on Prudential Norms:

Banks are required to classify the advance accounts in terms of the international practices and prudential norms.

The existing RBI guidelines regarding non-performing assets are given below:

Non-Performing Assets:

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

A Non-Performing Asset (NPA) is a loan or an advance where:

(i) Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.

(ii) The account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC) for more than 90 days.

(iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

(iv) For agricultural crop loans, the installment of principal or interest thereon remains overdue for two crop seasons for short-duration crops.

(v) The installment of principal or interest thereon remains overdue for one crop season for long duration crops under agricultural loan.

Banks should classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

'Out of Order' Status:

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or the credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Overdue:

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Income Recognition Policy:

The banks should have an objective policy of income recognition based on the record of recovery. Internationally, income from Non-Performing assets (NPA) is not recognised on an accrual basis but is booked as income only when it is actually received. Therefore, the banks should not charge and take to income account interest on any NPA.

However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin to cover the interest charged is available in the accounts.

Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA, at the close of any year, the entire interest accrued and credited to income account in the past periods should be reversed and kept in interest suspense account or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Leased Assets:

The finance charge component of finance income on the leased asset which has accrued and was credited to income account before the asset became non- performing, and remained unrealised should be either reversed or provided for in the current accounting period.

Appropriation of Recovery in NPAs:

Interest realised on NPAs may be taken to the income account provided the credits in the accounts towards interest are not out of fresh/additional credit facilities sanctioned to the borrower concerned.

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs towards principal or interest due, banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

Computation of NPA Levels:

Banks should deduct the following items from the Gross Advances and Gross NPAs to arrive at the Net Advances and Net NPAs, respectively:

(i) Balance in Interest Suspense Account

(ii) DICGC/ECGC claims received and held, pending adjustment

(iii) Part payment received and kept in suspense account and

(iv) Total provisions held (excluding amount of technical write off and provision on standard assets)

For the purpose, the amount, of gross advances should exclude the amount of Technical Write off, including all outstanding loans and advances; including the advances for which refinance has been availed but excluding the amount of rediscounted bills. The level of gross and net NPAs will be arrived at in percentage terms by dividing the amount of gross and net NPAs by gross and net advances, computed as above, respectively.

Asset Classification:

Categories of NPAs:

Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realisability of the dues:

(i) Sub-standard Assets

(ii) Doubtful Assets and

(iii) Loss Assets

(i) Sub-standard Assets:

A sub-standard asset would be one that has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well-defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if the deficiencies are not corrected.

(ii) Doubtful Assets:

An asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make realisation of the out standings in an advance account highly questionable and improbable.

(iii) Loss Assets:

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspectors but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some residual salvage or recovery value.

14.7 Asset Structure of Commercial Banks

Banks, like other business firms, are profit-making institutions, though public-sector banks are also guided by broader social directives from the RBI. To earn a profit, a bank must place its funds in earning assets, mainly loans and advances and investments. While lending or investing, a bank must look at the net rate of return obtained and the associated risks of holding such earning assets. Furthermore, since a large part of its liabilities are payable in cash on demand, a bank must also consider the liquidity of its earning assets, that is, how easily it can convert its earning assets into cash at short notice and without loss.

Thus, the twin considerations of profitability and liquidity guide a bank in the selection of its asset portfolio. A bank tries to achieve the twin objectives by choosing a diversified and balanced asset portfolio in the light of institutional facilities available to it for converting its earning assets into cash at short notice and without loss and for short-term borrowing. In addition, it has also to observe various statutory requirements regarding cash reserves, liquid assets, and loans and advances. We describe below various classes of assets banks hold. They will also describe the uses of bank funds.

They are discussed in the decreasing order of liquidity and increasing order of profitability:

1. Cash:

Cash, defined broadly, includes cash in hand and balances with other banks including the RBI. Banks hold balances with the RBI as they are required statutorily to do so under the cash reserve requirement. Such balances are called statutory or required reserves. Besides, banks hold voluntarily extra cash to meet the day-to-day drawals of it by their depositors.

Cash as defined above is not the same thing as cash reserves of banks. The latter includes only cash in hand with banks and their balances with the RBI only. The balances with other banks in whatever account are not counted as cash reserves.

The latter concept (of cash reserves) is useful for money-supply analysis and monetary policy, where we need to separate the monetary liabilities of the authorities from the monetary liabilities of banks. Inter-bank balances are not a part of the monetary liabilities of the monetary authority, whereas cash reserves are. These balances are only the liabilities of banks to each other. So, they are not included in cash reserves.

2. Money at Call at Short Notice:

It is money lent to other banks, stock brokers, and other financial institutions for a very short period varying from 1 to 14 days. Banks place their surplus cash in such loans to earn some interest without straining much their liquidity. If cash position continues to be comfortable, call loans may be renewed day after day.

3. Investments:

They are investments in securities usually clas-sified under three heads of (a) government securities, (b) other approved securities and (c) other securities. Government securities are securities of both the central and state government including treasury bills, treasury deposit certificates, and postal obligations such as national plan certificates, national savings certificates, etc. Other approved securities are securities approved under the provisions of the Banking Regulation Act, 1949. They include securities of state- associated bodies such as electricity boards, housing boards, etc., debentures of LDBs, units of the UTI, shares of RRBs, etc.

A large part of the investment in government and other approved securities is required statutorily under the SLR requirement of the RBI. Any excess investment in these securities is held because banks can borrow from the RBI or others against these securities as collateral or sell them in the market to meet their need for sh. Thus, they are held by banks because they are more liquid than and advance even though the return from them is lower than from loans and advances.

4. Loans, Advances and Bills Discounted-or Purchased:

They are the principal component of bank assets and the main source of income of banks. Collectively, they represent total 'bank credit' (to the commercial sector). Nothing more need be added here, bank advances in India are usually made in the form of cash credit and overdrafts. Loans may be demand loans or term loans. They may be repayable in single or many installments. We explain briefly these various forms of extending hank credit.

(a) Cash Credit:

In India cash credit is the main form of bank cre-dit. Under cash credit arrangements an acceptable borrower is first sanctioned a credit limit up to which he may borrow from the bank. But the actual utilization of the credit limit is governed by the borrower's 'withdrawing power'. The sanction of the credit limit is based on the overall creditworthiness of the borrower as assessed by the bank.

The 'withdrawing power', on the other hand, is determined by the value of the borrower's current assets, adjusted for margin requirements as applicable to these assets. The current assets comprise mainly stocks of goods (raw materials, semi-manufactured and finished goods) and receivables or bills due from others. A borrower is required to submit a 'stock statement' of these assets every month to the bank.

This state-ment is supposed to act partly as evidence of the on-going production/ trade activity of the borrower and partly to act as a legal document with the bank, which may be used in case of default of bank advances.

To cover further against the risk of default, banks impose 'margin require-ments' on borrowers, that is, they require borrowers to finance a part of their current assets (offered as primary security to banks) from their owned funds of other sources. (In addition, banks ask for second surety for whatever credit is granted.)

The advances made by banks cover only the rest (on average, the maximum of about 75 per cent) of the value of the primary security. The margin requirements vary from good to good, time to time, and with the credit standing of the borrower. The RBI uses variations in these requirements as an instrument of credit control.

In Case of acute shortage of particular commodities bank financing against the inventories of such commodities can be cur-tailed by raising the margin requirements for such commodities. Keep-ing in view the importance of the cash credit system in banking India.

(b) Overdrafts:

An overdraft, as the name suggests, is an advance given by allowing a customer to overdraw his current account up to agreed limit. The overdraft facility is allowed on only current accounts. The security for an overdraft account may be person shares, debentures, government securities, life insurance policies, or fixed deposits.

An overdraft account is operated in the same way as a current account. The overdraft credit is different from cash credit in two respects of security and duration. Usually, for cash credit, the security offered is current assets of business, such as inventories of raw materials, goods in process or finished goods, and receivables.

In the case of overdraft, the security is generally in the form of financial assets held by the borrower. Then, generally, the overdraft is a temporary facility, whereas the cash credit account is a longer-run facility. Also, the rate of interest on overdraft credit is somewhat lower than on cash credit because of the difference in risk and servicing cost involved. In all other respects, overdraft credit is like cash credit. In the case of overdrafts, too, interest is charged only on credit actually utilised, not on the overdraft limit granted.

(c) Demand Loans:

A demand loan is one that can be recalled on demand. It has no stated maturity. Such loans are mostly taken by security brokers and others whose credit needs fluctuate from day today. The salient feature of a loan is that the entire amount of the loan sanctioned is paid to the borrower in one lump sum by crediting the whole amount to a separate loan account.

Thus, the whole amount becomes immediately chargeable to interest, whatever the amount the borrower actually withdraws from the (loan) account. This makes loan credit costlier to the borrower than (say) cash credit.

Therefore, businessmen in need of supplementing their working capital prefer to borrow on cash credit basis. On the other hand, banks prefer demand loans, because they are repayable on demand, involve lower adminis-trative costs, and earn interest on the full amount sanctioned and paid. The security against demand loans may also be personal, financial assets, or goods.

(d) Term Loans:

A term loan is a loan with a fixed maturity period of more than one year. Generally this period is not longer than ten years. Term loans provide medium-or long-term funds to the borrowers. Most such loans are secured loans. Like demand loans, the whole amount of a term loan sanctioned is paid in one lump sum by crediting it to a separate loan account of the borrower. Thus, the entire amount becomes chargeable to interest.

The repayment is made scheduled, either in one installment at the maturity of the loan or in few installments after a certain agreed period. For making big term loans (of say, Rs. one crore or more) to big borrowers, banks have parted using the consortium method of financing in a few cases.

Under this method, a few banks get together to make the loan on participation basis. This obviates the dependence on multiple banking under which a borrower borrows from more than one bank to meet his credit needs. Consortium banking can make for better credit planning. Term loans as a form of bank credit are gaining rapidly in importance.

Various financial assets of a commercial bank

Liquidity and Profitability:

In order to be able to meet demands for cash as and when they are made a bank must not only arrange to have sufficient cash available but it must also distribute its assets in such a way that some of them can be readily converted into cash.

Thus, the bank's cash reserves can be reinforced quickly in the event of heavy drawings on them. Assets which are readily convertible into cash are called liquid assets, the most liquid being cash itself. The shorter the length of a loan the more liquid because it will soon mature and be repayable in cash; the less profitable because, other things being equal the rate of interest varies directly with the loss of liquidity experienced by the lender.

Thus a bank faces something of a dilemma in trying to secure both liquidity and profitability. It satisfies these apparently incompatible re-quirements in the way it distributes its assets. These assets have been arranged in the following table with the most liquid but least profitable ones at the top and the least liquid but most profitable towards the bottom.

The rupee assets of the banks include the notes and coin held in their vaults and the bankers' balances at the Central Bank are part of the banks' reserves. The bankers' balances at the Central Bank are a bit like your own deposit at a bank.

Just as you sign cheques to pay your debts or expenditures, banks will meet their balances at the Central Bank. The banks also hold some liquid assets and these are loans to financial intermediaries, government bills and other securities.

These liquid assets earn a rate of interest, but banks make the most of their money by giving loans and overdrafts to people and business. These items come under the heading of advances. The banks also make money by lending in other currencies to businesses, other banks and governments.

Cash-in-Hand:

It represents a bank's holding of notes and coins to meet the immediate requirements of its customers. Nowadays, there is no limit set on the amount of cash which banks in India must hold and it is taken for granted that they will hold enough to maintain their depositors' confidence. The general rule seems to be to hold something in the region of 4% of total assets in the form of cash.

Cash at the Central Bank:

It represents the commercial banks' accounts with the central bank. When banks in India require notes or corns they obtain them from the Central Bank by drawing on their accounts there in the same way as their customers obtain it from them. The banks also use their central bank accounts for setting debts among themselves. This process is known as the clearing system.

Money at Call and Short Notice:

This consists mainly of day-to-day loans to the money market but also includes some seven-day and fourteen- day loans to the same body and to the stock exchange. This asset is by nature very liquid and enables a bank to recall loans quickly in order to reinforce its cash.

Being so very short these loans carry a very low rate of interest; consequently they are not very profitable. The money market consists of discount houses. Then, main function is to discount bills of exchange.

These bills may be commercial bills, or Treasury Bills. A bill is a promise to pay a fixed amount usually in three months' time. Thus a firm, or the Treasury, can borrow money by issuing a promise to pay in three months. A discount house may buy such a bill at a discount, i.e., it may buy a Rs.100 bill for Rs 90.00. In this case the rate of discount is 10% (per annum).

This discount house may later sell the bill to a bank, i.e., rediscount it, but when it matures the bill will be presented for payment at its face value. The discount houses finance their operations by borrowing 'on call or at short notice' from the commercial banks and they make their profits out of the fractional differences between the rates of interest they have to pay the banks and the slightly higher rates they can charge for discounting bills.

Bills Discounted:

Another link between the banks and the money market lies in the way in which the banks acquire their own portfolios of bills. By agreement the banks do not tender directly for these bills but instead buy them from the discount houses when they have two months or less to run. They also buy them in such a way that a regular number mature each week, thus providing an opportunity for reinforcing their cash bases.

Thus, the money market provides two notable services to the banks. It enables them to earn some return on funds which would otherwise have to be held as cash and it also strengthens their liquidity as regards their bill portfolios.

Government Securities with One Year or Less to Maturity:

These securities consist of central government stocks and nationalised industries' stocks guaranteed by the government. Since they are so close to the date when they are due for redemption, i.e., repayment at their face value, they can be sold for amounts very near to that value. Thus banks can sell them to obtain cash without suffering any loss. They are very liquid assets.

Certificates of Deposit:

These are receipts for specified sums deposited with an institution in the banking sector for a stated period of up to five years. They earn a fixed rate of interest and can be bought and sold freely.

14.8 Provision for Non-Performing Assets

Loans, advances, discounting of bills, purchasing of bills and the like are the main source of income for any bank. Some of such assets may not bring in any income to the banks. In accordance with International Accounting Standards, a distribution is made on the treatment of income on different advances by classifying into "performing assets" and "non-performing assets" (NPA).

Meaning of Non-performing Assets

An asset is said to be a non-performing asset, when it ceases to generate income for a bank. The RBI has given certain guidelines for treating an asset as NPA. Some of them are provided as follows:

(i) Term loans: When interest or instalment on loans is overdue for more than 90 days, the account is to be treated as NPA.

(ii) Cash credits and overdrafts: When a cash credit or O/D account remains out of order for more than 90 days, it will be considered as NPA.

An account is treated as "out of order", if any one of the following conditions is satisfied:

(a) The outstanding balance remains continuously in excess of the sanctioned limit and or drawing power.

(b) Even if the outstanding balance is well within the sanctioned limit/drawing power, if there are no credits in the account continuously for 90 days as on the date of the balance sheet.

(c) If the credits in such accounts are not sufficient enough to meet the interest debited during the same period.

(iii) Bills purchased and discounted: When the bill remains overdue for a period of more than 90 days from its due date, it is to be treated as NPA.

(iv) Agricultural advances: Loan granted for short-duration crops is to be treated as NPA, if interest or principal remains overdue for two crop seasons. Loan granted for long-duration crops is to be treated as NPA, if the instalment of principal or interest remains overdue for one crop season.

(v) Other advances: Any other credit facility is to be treated as NPA, if the amount to be received remains overdue for a period of more than 90 days.

Provisions for Non-performing Assets

To create provision for NPAs, the advances of a bank are classified into four categories, with variable provisions explained as follows:

Category I: Standard assets or performing assets: Dues are required to make a provision of a minimum of 0.40% on standard assets also on global loan portfolio basis and not on domestic advances alone.

Category II: Sub-standard assets:

(i) A general provision of 10% on total outstanding has to be created without making any allowance for Export Credit Guarantee Corporation (ECGC).

(ii) However, the "unsecured exposures", which are categorized as sub-standard assets will attract additional provision of 10%. That means 10% + 10% = 20% on the outstanding balance. (When the realizable value of the security is not more than 10% of the outstanding exposure, it is known as unsecured exposure.)

(iii) When loans are classified as NPAs and also as sub-standard, a provision of 20% is required.

(iv) W.e.f. the year ending on 31 March 2005, the banks are permitted to spread the additional provision consequent upon the reduction in the transition period from sub-standard to doubtful asset from 18 to 12 months over a 4-year period, with a minimum of 20% each year.

Category III: Doubtful assets:

(i) If the debt is not covered by realizable value of the security, 100% provision should be created.

(ii) If the debt is secured, then provision is to be made as follows:

Provisions	**Percentage**
Up to 1 Year	20
1–3 Years	30
More than 3 Years	100

Category IV: Loss assets: This category has been identified as assets, which have lost value but not written off. The entire assets are to be written off completely. However, if the assets are to be retained in the books of accounts for any specific reason, then 10% provision is required to be created.

Summary

A bank is an organization, which may involve anumber of financial trading activities, regulated bythe Banking Regulations Act, 1949.

Banking means accepting, for the purpose oflending or investment, of deposits of money fromthe public, repayable on demand or otherwise,and withdrawals by cheque, draft or otherwise. Acompany that transacts the business of banking iscalled a bank company.

A bank which is included in the second scheduleof RBI Act, 1934 is referred as "Scheduled Bank".

Business of banking companies involves thefollowing activities:

1. Borrow or raise money.

2. Carry on and transact guarantee and indemnitybusiness.

3. Undertake and execute trusts.

4. Acquire and undertake the whole or any partof the banking business of any person orcompany.

5. Contract for public and private loans, negotiate

and issue them.

6. To engage in any business, which is authorized by the Govt. No banking company is permitted to carry on business other than those specified in Section 5(2) of the Act.

Banking Regulation Act stipulates certain minimum amount of paid-up capital and reserve (for details refer the text).

For important provisions of the Banking Regulation Act, 1949 refer the main part of the text.

Main features of banking accounting:

(i) slip system of posting,

(ii) voucher summary sheets,

(iii) self-balancing system of ledgers,

(iv) daily trial balance and

(v) double voucher system.

Keywords

- Non performing asset
- Commercial bank
- Paid up capital
- Statuary Reserve fund

Self Assessment

1. A banking company in India is regulated by

A. The Companies Act
B. Reserve Bank of India
C. Banking Regulation Act
D. all of these

2. Which of the following forms of business is notpermitted to carry out by banking companies, asper Section 6 of the Banking Regulation Act?

A. buying, selling and dealing with bullion
B. providing of safe deposit values
C. buying, selling or bartering of goods
D. undertaking and executing trusts

3. Every banking company is required to preparefinal accounts in conformity with

A. third schedule of the Banking Regulation Act, 1949
B. sixth schedule of the Companies Act, 1956
C. guidelines of RBI
D. none of these

4. As per RBI guidelines, the percentage of profit tobe transferred to statutory reserve is

A. 20
B. 25
C. 10
D. 12.5

5. Which of the following is not classified as“Capitalized expenses”?

A. preliminary expenses
B. brokerage
C. share-selling commission
D. depreciation on assets

6.Which of the following is not the permissiblefactor to form a subsidiary company?

A. the undertaking and executing of trust
B. the undertaking of the administration of estates as execute
C. the undertaking of another sick banking company
D. the carrying-on business of banking exclusively outside India, with prior permission of the RBI

7. The inter-office adjustment balance (net) shouldbe shown under the head

A. other Liabilities and provisions
B. borrowings

C. interest expended
D. none of the above

8. “Provision for income tax” is to be shown underthe head

A. other assets
B. other liabilities
C. operating expenses
D. loans and advances

9. Which of the following is not a contingentliability?

A. guarantees given on behalf of customers
B. acceptances, endorsements and other obligations
C. claims against the bank, not acknowledged as debts
D. traveller’s cheques, gift cheques and the like

10. Which of the following is not included under thehead “advances”—Schedule 9:

A. cash credit
B. overdrafts
C. Money as call
D. purchasing and discounting of bills

Answer for Self Assessment

1.	D	2.	C	3.	A	4.	B	5.	D
6.	C	7.	A	8.	B	9.	D	10.	C

Review Questions

1. 1 Define Bank.
2. What do you mean by a “banking company”?
3. Mention some forms of business that a banking company can carry on.
4. What is the accounting year for banking companies?
5. What is “statutory reserve”?
6. Define banking and banking company. Explain indetail the forms of business a banking companymay carry on as per Section 6 of the BankingRegulation Act.
7. Explain in detail the important legal provisionswith special reference to fi nal accounts of abanking company.
8. What are the different types of provisions forNPAs as on date?

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