Private Sector Financial Reporting

National Academy of Audit and Accounts
Shimla

Contents

Preface

This text book on Private Sector Financial Reporting is prepared to meet the needs of IA&AS Officer Trainees during Semester-II of their training at the National Academy of Audit and Accounts, Shimla. This subject is one of the 12 core subjects that are taught to the Officer Trainees at the Academy. These subjects and contents within each subject are highly interlinked to create a body of knowledge that can be considered as fundamental to Public Sector auditing and accounting.

Since the government operates commercial entities, adopts commercial principles within its core operations wherever required and regulates the Private Sector, it is inevitable that Public Sector audit should not only know about accounting and auditing in Public Sector but also in the Private (corporate) Sector.

Officer Trainees are initially taught about book-keeping in Private (corporate) Sector, as well as the financial framework in Public Sector (government). The knowledge gained in this subject is used then as a building block to teach them financial reporting in Private Sector.

This book has been written in a simple language and with a lucid style so as to explain the principles and practices of financial reporting in the Private Sector in a manner understandable to all. Each chapter of the book has been written in order to meet the requirements of the syllabus prescribed for IA&AS Officer Trainees. Several texts, interpretations and problems have been carefully selected from the publications of different academic and professional institutes and examinations to supplement the theoretical aspects covered in the book. While a vast body of literature is available on the Private Sector financial reporting in the academic realm to cater to the interests of both the amateur as well as the advanced learner, this book stands out as it has been designed to meet the exact requirements of a newly recruited IA&AS Officer Trainee.

Further, consequent upon the application of the Companies Act 2013, various schedules, forms & formats have been revised in this book, and a sincere attempt has been made to incorporate all the changes and modifications as per the latest Act. An attempt has also been made, in the form of illustrations, to interpret the selected Accounting Standards from the view point of an Accountant, as well as an Auditor.

I would like to put on record here my thanks to Mr. Ranjeet Singh, Sr. Audit Officer (Training), without whose active involvement and extensive inputs this book would not have been possible. We have also benefitted immensely from the knowledge and experience of many other officers who have taken sessions at the Academy for the Officer Trainees, which have helped us to streamline our thoughts of the subject of this book.

While we have taken every possible effort to remove printing errors, it is possible that some may still remain. If the reader comes across any such error, s(he) is requested to point out the same out to us so that we can make necessary corrections in the forthcoming editions.

I am confident that in its present form the book will not only be very useful to the Officer Trainees, but also to all other young officers and staff of the department who are interested in the subject.

Further suggestions for improvement of the book are eagerly solicited.

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CHAPTER 1

Conceptual Framework of Financial Reporting

Introduction

"Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof"[1]

According to this definition, accounting is simply an art of record keeping. The process of accounting starts by first identifying the events and transactions which are of financial character and then be recorded in the books of account. This recording is done in journal or subsidiary books, also known as primary books. The record keeping system provides for suitable classification of transactions and events as well as their summarization for ready reference. After the transaction and events are recorded, they are transferred to secondary books. i.e., Ledger. In ledger transactions and events are classified in terms of income, expense, assets and liabilities according to their characteristics and summarized in profit & loss account and balance sheet.

Do financial statements capture the activities of the entity?

Financial reporting process is conceived as consisting of four procedural steps[2]:

1. Perception of the significant activity of the accounting entity and in the environment in which the entity performs. Implicit in this perception is the belief that financial transactions represent the significant activities of the entity.

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1 Definition of accounting formulated in 1961 by the Committee on Terminology set up by the American Institute of Certified Public Accountants formulated.

2 Conceptualised by Bedford - Bedford, N.M. & Baladouni, V. (1962), "A Communications Theory Approach to Accountancy", The Accounting Review, 37(4) October, pp.650-59

2. Symbolising the perceived activities in such fashion that a database of the activities is available that can then be analysed to grasp an understanding of the interrelationship of the mass of perceived activities. Conventionally, this symbolisation has taken the form of recordings in accounts, journals, and ledgers using well-established bookkeeping and measurement procedures.
3. Analysis of the model of activities in order to summarize the interrelationships among activities and to provide a status picture or map of the entity. Traditionally, this analysis process has been viewed as one of developing accounting reports to provide insights into the nature or entity activities.
4. Communication (transmission) of the analysis to users of the accounting products to guide decision makers in directing future activities of the entity or in changing their relationship with the entity.

First two steps constitute the process of accounting measurement, the quantification of an entity's past, and present, or future economic phenomena on the basis of observations and rules. Implicit in this conception are the requirements that (a) there exist some attribute or feature of a business-related objects or event (e.g. the value of an asset) worthy of measurement and (b) there exist a means of make in the measurements (e.g., the use of exchange prices to value enterprise assets).

Step 3 and 4 of the financial reporting process constitute disclosure. Hence, measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated.

Concept of Financial Reporting

Financial Reporting is the communication of financial information of an enterprise to the external world. The entire process of financial reporting has two inter related dimensions; **(a)** quantification, measurement and recording of organisational activities in financial terms based on certain well established accounting principles and **(b)** disclosure of the information to the users /stakeholders in the form of summarisation/analysis/developing accounting reports etc.

Corporate financial reporting is a series of activities that allows companies to record operating data and report accurate accounting statements at the end of each month, quarter and the year. It involves preparing annual financial statements in accordance with corporate policies, industry practices and regulatory guidelines.

Financial statements are a structured representation of the financial position of an entity at the end of the year and its financial performance during the year. The objective is to provide a true and fair view of the financial position, financial performance and cash flows of an entity. To meet this objective, financial statements provide information about an entity's assets, liabilities, income and expenses, including gains and losses, equity, contributions by and distributions to owners in their capacity as owners; and cash flows. This information is supplemented by disclosures and notes to accounts.

Annual Financial Statements of the Company include:

A Balance Sheet at the end of the financial year;
A Profit and Loss Account of the financial year;
Cash Flow Statement for the financial year;
A Statement of change in equity, if applicable.

In addition, any financial facts significant enough to influence the judgment of an informed reader are disclosed. Accounting policies, inventory methods, alternative measures etc., are explained as notes to the financial statements. Information such as changing prices disclosures or oil and gas reserves information for example is given as supplementary information.

The financial statements, augmented by footnotes, disclosures and supplementary data ('Notes on Accounts' or 'Notes to the Accounts' in India) are intended to provide relevant, reliable and timely information essential for meeting the decision making needs of a broad range of users. Hence they are called general purpose financial statements. The one designed to meet the financial information needs of specific users is called special purpose financial statement.

Users of the Financial Reports

Different classes of users use financial information for different purposes. Different user groups have different objectives and diverse information needs. General purpose financial statements are prepared to meet the common needs of all types of users. Traditionally, investors (both existing and potential) are singled out as the dominant user group of published financial statements. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. It is generally viewed that the provision of financial statements, which meet the investor's needs, will also meet most of the needs of other users.

The Framework specifies present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public as the users of financial statements. Financial reporting is mainly intended to meet the following information requirements of different users:[3].

- Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

3 These are the major objectives of financial reporting according of FASB of USA. They are virtually same for all the financial reporting standard setting bodies

- Should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
- To assess the amount, timing and uncertainly of prospective net cash inflows to the related enterprise.
- About an enterprise's financial performance during a period.
- About how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.
- Financial reporting should provide information that is useful to managers and directors in making decisions in the interest of owners
- About how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.

Management accountability is a broad concept that encompasses stewardship. Management's responsibility to manage assets with care and trust is its fiduciary responsibility. The accountability relationship may be created by a constitution, a law, a contract an organization makes, a custom or even by informal moral obligation. Management of an enterprise is periodically accountable to the owners not only for safekeeping of resources but also for their efficient and profitable use.

Management accountability objective mainly emphasizes reliability aspect of accounting information. Verifiability of reported information is considered dominante consideration for inclusion of any piece of information in the financial statement.

Financial reporting is central to the process of allocating financial resources in capital markets. This involves decision-usefulness of the information. Capital market influences are having a major role in shaping the financial reporting. The objective of decisional usefulness has formally been incorporated into the conceptual frameworks for the preparation and presentation of financial statements.

Qualitative Characteristics of Information in Financial Report

Qualitative characteristics are the attributes that make the information provided in the financial statement useful to the users. Institute of Chartered Accountants of India (ICAI) Conceptual Framework[4] earmarks four principal qualitative characteristics viz., Understandability, Relevance, Reliability and Comparability.

4 All the accounting standard setting organisations identify the users, their requirement and prepare a conceptual frame-work for financial reporting that meets the purposes. The conceptual framework provides the conceptual basis for generally accepted accounting principles. These principles in turn form the basis for formulating accounting standards.

Understandability: Information in annual reports should be presented in such a way that it is readily understandable by users. ICAI Conceptual Framework states that the criterion of understandability requires that the users have a reasonable knowledge of business and economic activities, accounting, and a willingness to study the information with reasonable diligence. It has also suggested that information, which is relevant to the economic decision making needs of some of the users should not be excluded merely on the ground that it may be difficult to understand by others.

Relevance: The concept of relevance is directly related to the decision making needs of users. Information is said to be relevant if it can influence 'the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluation. It is suggested that all those items of information, which may aid the users in making predictions or decisions, should be reported. Information, which does not assist users in making decisions is irrelevant and hence, should be omitted. Thus, relevance is the dominant criterion of taking decisions regarding information disclosure. Timeliness is an important aspect of relevance. Information loses value rapidly in the financial world. As time passes and the future becomes the present, past information becomes increasingly irrelevant.

Reliability: Information is reliable if it is free from material error and bias, and faithfully represents what it purports to represent. Information is reliable to the extent a user can depend upon it to represent the economic conditions or events that it aims to represent. Being free from bias implies impartial measurement and reporting by enterprise of its events and transactions.

Comparability: The ICAI Conceptual Framework emphasizes that users must be able to compare financial statements, of an enterprise through time in order to identify trends in its financial position, performance and cash flows, and of different enterprises in order to evaluate their relative financial position, performance and cash flows. For this purpose, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way. The Framework indicates that the important implication of comparability is that users should be informed of the accounting policies employed in the preparation of financial statements, any changes of those policies and the effects of such changes. For achieving comparability, the Framework (paragraph 40) suggests compliance with relevant accounting standards including the disclosure of accounting policies used by the enterprise.

Materiality: According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic. A piece of information is considered to be material when its disclosure or non-disclosure would affect decision or would make a difference in the valuation of the firm. In the ICAI Conceptual Framework, materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

Reports other than Financial Statements

Apart from accountability to shareholders, there is a growing worldwide trend of holding companies accountable to the public at large. Such a trend is responsible for changing the disclosure practice of companies to a considerable extent. Such a movement is creating awareness about the disclosure needs of 'non-financial shareholders' such as trade unions (interested in terms of employment), government (interested in the macroeconomic impact of operations of corporate sector) and general public (interested in social and environmental impact of corporate actions). Voluntary reporting of employee information, environmental information and other corporate social responsibility report (e.g. social balance sheet) are example of disclosure arising from non-financial influences.

It may be mentioned that the term financial reporting is not restricted to information communicated through financial statements. Financial reporting includes other means of communicating information that relates, directly or indirectly to the information generated through accounting process. It may take various forms and relate to various matters, arising out of convention, regulatory requirements or on voluntary basis.

A number of documents and avenues of communication are available through which companies provide information about its state of affairs to the external users of such information, for example, annual report, interim report, employee report, environmental report, communications with analysts, letters to shareholders and debt holders, question and answer session held at annual general meeting, telephone conversations, speeches made by company officials at stock exchanges and so on.

Despite the existence of different sources of information, the annual report is regarded as the most important source of information about a Companies affairs. A typical corporate annual report usually contains a balance sheet, profit and loss account, cash flow and/ funds flow statement, and directors' report. Besides, the details of information and additional information are provided in the schedules and notes on accounts, which from parts of financial statements. Annual reports often contain useful supplementary financial and statistical data as well as management comments. Many companies in India now include Management Discussion and Analysis (MD & A) report, corporate governance report, chairman's statement, historical summary, operating positions, highlights of important data etc.

Quality of Financial Reporting

Ideally, financial statements should reflect an accurate picture of a company, its financial condition and performance. Management has considerable discretion within the overall framework of generally accepted accounting principles. As results, there are scopes for managements to 'manipulate' the accounts. Such manipulations mainly relate to management of bottom line (profit or loss) and commonly referred to an earnings management. If the financial statements distort economic reality, capital will be deployed sub-optimally; resources will be misallocated; investors will pay a huge opportunity cost by investing in companies with unrealistic, inflated values and better investment opportunities may get bypassed. Regulations on financial reporting generally provides for penalties and other measures to deter accounting frauds.

It is important that all aspects of financial reporting—the financial statements, the notes, disclosures, the president's letter, and management's discussion and analysis—be read and understood. At the heart of high-quality financial reporting is full disclosure. As the disclosure of accounting information is not costless, preparers of financial statement have to make judgments on the allocation of accounting information among various users groups. From regulator's standpoint, leaving the decision about disclosure in the hands of corporate management or market forces, has not been viewed favourably. It is possible for management to disclose information that is considered helpful to facilitate its external relations programmes and still withhold certain pieces of vital information that is useful for decision making by the users. Hence, greater control over corporate reporting is imposed whenever it is perceived that there is failure to adequately respond to express information needs of different stakeholders. Thus, the scope of negative sanctions of regulatory controls over corporate disclosure increases when users groups perceive that there are deficiencies on the part of companies in providing adequate disclosure.

Accounting Standards

In preparing financial statements, accountants are confronted with the potential dangers of bias, misinterpretation, inexactness, and ambiguity. In order to minimize these dangers, the accounting profession has attempted to develop a set of standards that is generally accepted and universally practiced. Without this set of standards, each accountant or enterprise would have to develop its own standards, and readers of financial statements would have to familiarize themselves with every Companies peculiar accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared.

The common set of standards and procedures called generally accepted accounting principles (often referred to as GAAP). The term 'generally accepted' can mean either that an authoritative accounting rule-making national body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application. International Accounting Standards (IAS) /International Financial Reporting Standards (IFRS) are the result of the efforts to converge all the national standards into international standards.

The accrual basis of accounting is used in preparing the basic financial statements. The accrual basis provides for (1) reporting revenues in the period they are earned (which may not be the same period in which the related cash is received), and (2) reporting expenses in the period they are incurred (which may not be the same period in which the related cash is paid).

Going concern is one the fundamental assumptions in accounting on the basis of which financial statements are prepared. Financial statements are prepared assuming that a business entity will continue to operate in the foreseeable future without the need or intention on the part of management to liquidate the entity or to significantly curtail its operational activities. Therefore, it is assumed that the entity will realize its assets and settle its obligations in the normal course of the business.

Role of Auditors

The audit provides an external and objective check on the measurement and disclosure aspects of corporate financial reporting. Although, Management is responsible for the preparation of financial statement including the notes, the auditor through the auditor's report states whether financial statement fairly presents, in all material respects the financial position, the results of operations and the cash flows for the accounting period. The auditor is responsible for seeing that the financial statements issued conform to generally accepted accounting principles. Thus, the auditor must agree that accounting policies adopted by the management are appropriate and all estimates are reasonable. Any departure from generally accepted accounting principles would result in a qualified opinion. Auditor's report is an important accompaniment of financial statements.

CHAPTER 2

Elements of Financial Statements

The objective of financial statements is to provide information that meets the needs of users about the (a) financial position at the end of the year which is primarily provided in the balance sheet (b) financial performance during the year which is primarily provided in the statement of profit and loss accounts and (c) cash flows of the entity in a cash flow statement. Schedules to accounts are part of balance sheet and statement of profit and loss. Notes to accounts are the disclosures about the assumptions made.

There are three underlying assumptions in the financial statements. They are prepared on *accrual basis* where the effects of the transactions (other events) are recognised when they occur. They are recorded and reported in the financial statements of that period. Second assumption is *going concern* which means the entity is expected to continue its operations for foreseeable future. Third assumption is *consistency*. The accounting policies are to be followed consistently from one period to another to enable a comparison. A change in an accounting policy is made only in certain exceptional circumstances.

Financial statements are required to have certain *qualitative characteristics*, certain attributes that make the financial information useful to users. *Understandability*, *relevance*, *reliability* and *comparability* are identified as four principal qualitative characteristics. Relevance includes materiality. Reliability includes faithful representation, neutrality, prudence, completeness and substance over the form. Though each attribute is important, in order to meet the objective of financial statements there is a need achieve an appropriate balance among the characteristics.

Elements

Financial statements portray the financial effects of *transactions* (& other events) by grouping them into *broad classes* according to their economic characteristics. These broad classes are called *elements* of financial statements.

Assets, liabilities and *equity* are the elements that portray the financial position (at the end of the year) in the balance sheet. *Income* and *expenses* portray financial performance and changes in financial performance (during the year) in the profit and loss accounts. Revenues include *gains*, expenditure includes *losses*. Revenues, gains, expenses, and losses describe changes in equity due to profit-generating transactions. Investments by owners and distributions to owners can also be considered as elements.

Assets, liabilities and equity are directly related to the measurement of financial position. Income and expenses are directly related to measurement of profit or loss.

Definitions of elements

Definitions only identify the essential features of elements. Definitions do not indicate the specific criteria the elements have to meet before they are recognised in the balance sheet or profit and loss account.

- An *asset* is a resource controlled by the entity as a result of past events from which future economic benefits are expected to flow to the entity.
- A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity
- *Equity* is the residual interest in the assets of the entity after deducting all its liabilities.
- *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, (other than those relating to contributions from equity participants).
- *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, (other than those relating to distributions to equity participants).

Assets

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Benefit may flow to the entity in a number of ways; for example in the production of goods or services to be sold by the entity. Entity should have control over its assets. Some have physical form (plant and machinery) some do not (patents and copyrights). Sometimes there is legal right over ownership (property, receivables) sometimes may not (hire purchase of an asset). Entities normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; for example discovery of mineral deposits. The assets may be from past transactions or other past events.

Liabilities

An essential characteristic of a liability is that the entity has a present obligation which is a duty or responsibility to act or perform in a certain way. It normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to pay for goods and services received; irrevocable means that there are economic consequences of failing to honour the obligation. The settlement of a present obligation usually involves the entity giving up resources (outflow of resources) embodying economic benefits in order to satisfy the claim of the other party. It can be by way of payment of cash, transfer of other assets, provision of services, replacement of that obligation with another obligation etc. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions', for example provision for pension obligation etc.

Equity

Equity arises primarily from two sources: (a) amounts invested by shareholders when they purchase shares or stock from the entity, *paid-up capital* and (b) *retained earnings,* amounts earned by the corporation on behalf of its shareholders and not (yet) distributed to them as dividends.

Investments by owners (stock in exchange for cash) result increase in equity. Distributions (dividends) to owners decreases equity. Revenues, gains, expenses, and losses also describe changes in equity.

Funds contributed by owners, *reserves representing appropriations of retained earnings*, *unappropriated retained earnings* and *reserves representing capital maintenance adjustments* are be shown separately in the financial statements in order to reflect the ownership interests, differing rights in relation to receipt of dividends, repayment of capital, legal or other restrictions that apply to equity etc.

The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.

Income and Expenses

Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. It is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that arise otherwise. What one means by ordinary activities of one industry would vary from other industry. The source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future.

Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent. The definition of income includes gains and unrealised gains. Gains may arise from other than ordinary activities; disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the entity (cost of goods sold, wages, and depreciation), as well as losses (disposal of assets). They take the form of an outflow or depletion of assets or enhancement of liabilities. Losses may, or may not, arise in the course of the ordinary activities of the entity. When losses are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Recognition of the Elements of Financial Statements

An item that meets the definition of an element should be recognised if: (a) it is probable that any future economic benefit associated with the item will flow *to or from* the entity; and (b) the item has a *cost or value* that can be *measured with reliability*. Recognition is the process where an item meets the definition of an element and satisfies the criteria for recognition. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. An item that meets the definition and recognition criteria for a particular element (for example an asset), automatically requires the recognition of another element (for example income), '*interrelationship*'.

The Probability of Future Economic Benefits

The concept of probability is used to refer to the degree of uncertainty that the future economic benefits (associated with the item) will flow to or from the entity. Assessment of the degree of uncertainty is made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, some degree of non-payment is normally considered probable.

Reliability of Measurement

An item possesses a cost or value that can be measured with reliability. In many cases, cost or value must be estimated. It should be a reasonable estimate and such claim need to be disclosed in the notes, explanatory material etc. An item that fails to meet the recognition criteria at a particular point in time, may qualify for recognition at a later date as a result of subsequent circumstances or events.

Recognition of Assets

An asset is recognised in the balance sheet when it is probable that the future economic benefits (associated with it) will flow to the entity and the asset has a cost or value that can be measured reliably. An asset is not recognised when expenditure has been incurred and for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss.

Recognition of Liabilities

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. They may meet the definition of liabilities and the recognition criteria in the particular circumstances, may qualify for recognition. In such circumstances recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable). Income is recognized for those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. Recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset. An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, liability under a product warranty.

Measurement of the Elements of Financial Statements

Measurement is the process of determining the *monetary amounts at which* the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. Some of them are briefly given below.

Historical cost: Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost: Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value: Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

Present value: Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Conceptual framework for financial reporting establishes precise definitions and an overarching theory of account to facilitate preparation of accounting standard that are internally consistent.

*The above material is abstracted from the ICAI Conceptual Framework for Financial Reporting

CHAPTER 3

Corporate Financial Reporting in India

Regulation of the Corporate Sector in India

Ministry of Corporate Affairs (MCA) regulates the Corporate Sector through administration of Companies Act, 2013 and other allied Acts. Competition Commission (established under Competition Act, 2002) seeks to protect the interest of consumers and investors by preventing practices having adverse effect on competition and by promoting and sustaining competition in markets.

The Reserve Bank of India (RBI) is the regulator of Commercial Banks and the Banking System. RBI regulates and supervises the major part of the financial system. Its supervisory role extends to non-banking finance companies (NBFCs), Urban Cooperatives. Regional Rural Banks and the Co-operative banks are supervised by National Bank for Agriculture and Rural Development (NABARD) and housing finance companies by National Housing Bank (NHB). MCA regulates deposit taking activities of corporates other than NBFCs. RBI is the manager of foreign exchange.

The capital market, mutual funds, and other capital market intermediaries are regulated by Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector; and the Pension Funds Regulatory and Development Authority (PFRDA) regulates the pension funds.

The Securities and Exchange Board of India (SEBI), enacted under the Securities and Exchange Board of India Act, 1992 is meant to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

Fixed deposits and other banking products are regulated by the Reserve Bank of India (RBI), small savings products by the Government of India (GoI), mutual funds and equity markets by the Securities and Exchange Board of India (SEBI), insurance by the Insurance

Regulatory Development Authority of India (IRDA) and the New Pension Scheme (NPS) by the Pension Fund Regulatory and Development Authority (PFRDA).

Serious Fraud Investigation Office multi-disciplinary organization to investigate, detect and prosecute corporate frauds/ white collar crimes. It consists of experts in the field of accountancy, forensic auditing, law, information technology, investigation, company law, capital market and taxation

According to provisions of the Companies Act, a company, whose paid up share capital is five cores or more needs to appoint a full time Company Secretary in the rolls of the company. For companies whose capital is less than five crores, they need a registered and practicing Company Secretary to issue a compliance certificate. Company Secretary has many high level duties in an organisation which consist of governance rules and regulations, ensuring corporate conduct with respect to legal and regulatory requirements, overseeing management of employee benefits such as pension schemes and employee shares, looking into financial accounts, property administration and so forth. SEBI recognises a registered Company Secretary as the authorized person who can issue the different certificates on behalf of a company. The annual returns of a company need to be signed by a Company Secretary. They are qualified for these purposes and are members of Institute of Company Secretaries of India (ICSI), which is established by an Act of the Parliament.

In India, the Cost Accounting Records Rules set by the government for 44 industries deal with the various items of cost and the way in which they have to be reported in the Cost Statement in accordance with the cost accounting principles. They need to be audited by Cost Accountants. They are members of Institute of Cost Accountants of India (ICAI), established by an Act of the Parliament. They are qualified to carry out cost audits and certify accordingly.

Corporate Financial Reporting System in India

India is federal state with unitary basis. This is perhaps why unlike in the USA, there is no separate company law for any state in India. Apart from professional regulations, corporate financial reporting in India is governed primarily by the Companies Act 2013 (earlier Companies Act 1956). Another body that has a major influence in reshaping Indian Financial reporting is the Securities and Exchange Board of India (SEBI). The companies Act, 2013 prescribes the financial reporting requirement for all the companies registered under it. The reporting requirements that are imposed by the SEBI through its guidelines and through the listing agreements are in addition to those prescribed under the Companies Act. Listing Agreements is the standard agreement between a company seeking listing of its securities and the stock exchange where listing is sought.

SEBI is created with statutory powers for (a) Protecting the interests of investors in securities, (b) Promoting the development of the securities market and (c) Regulating the securities market. Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It has powers for (a) regulating the business in stock exchanges and any other securities markets, (b) registering and regulating the working of stock brokers, sub-brokers etc., (c) calling for information, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self-regulatory organization, mutual funds and other persons associated with the securities market and (d) prohibiting fraudulent and unfair trade practices.

SEBI has used its power to order changes in listing agreements and such changes are instrumental to bring about improvements in disclosure practices of listed companies in their annual reports. Some important requirements are as follows:

Dispatch of copy of complete & full annual report to the shareholders

Disclosure of Cash Flow Statement

Disclosure of material development and price sensitive information

Disclosure of interim unaudited financial results

Corporate Governance Report

Compliance with Accounting Standards issued by ICAI

SEBI requirements are to be followed by the companies listed on the Indian Stock Exchanges.

The Companies Act and the SEBI requirements together provide the legal framework of corporate reporting in India.

The Companies Act, 2013

The Companies Act, 2013 lays down detailed provisions for maintenance of books of accounts and the preparation and presentation of annual accounts. The Act also prescribes the mechanism for issuance of accounting standards. It specifies the roles and responsibilities of directors and also the matters to be reported upon by them in the annual reports of the companies. Audit of annual accounts is compulsory for all companies registered under it. The Act extensively deals with the qualification, appointment, removal, rights, duties and liabilities of auditors and provides contents of auditor's report. Penal provisions are provided for cases of delinquency or default by the management or auditor. As the preparation of financial statements presupposes the existence of a recording procedure of transactions of the reporting entities, the requirements as to the maintenance of books of accounts are also mentioned.

Companies Act, prescribes that financial statement of the Companies should be in accordance with the standards for accounting. Institute of Chartered Accountants of India (ICAI) established by the Chartered Accountants Act, 1949 formulates standards. They are examined by National Advisory Committee on Accounting Standards (NACAS) established by the Central Government.

Central Government in consultation with and on recommendation of NACAS approves and notifies the Accounting Standards, revisions from time to time. Individual Chartered Accountants are members of the ICAI and they are qualified to audit the financial statements.

Despite providing for detailed requirements in respect of maintenance of books of accounts, preparation of financial statements and audit of annual accounts by statutory auditors, the main thrust under the Companies Act is upon the presentation of a 'true and fair view' of the state of affairs and operating results of the reporting companies. The Act requires that at every annual general meeting, the Board of Directors of the company should place before the company:

- A balance sheet as at the end of the financial year exhibiting the true and fair view of the state of affairs of the company and shall be in the form prescribed (Schedule III in the Companies Act 2013):
- A statement of profit and loss account for the financial year exhibiting true and fair view of profit and loss of the company for the financial year and this be prepared in accordance with requirements of Schedule III of Companies Act 2013.

The annual accounts should be accompanied by narrative disclosure which embraces both qualitative and quantitative information. In most cases narrative disclosure are presented in textual form wherein more emphasis is laid on words than on figures. This requirement stems from the provisions of the Companies Act and that of the Accounting Standards. These disclosures are classified under two broad heads; (a) Accounting Policies and (b) Note to Accounts.

Published Financial Statements:

Annual Reports are a major vehicle through which Companies are publishing their financial statements. Like companies of any developed countries, annual reports of companies of India now include much more that the legal minimum requirements. Regarding elements of annual reports, the following are most common:

Notice of annual general meeting		Cash flow statement
Chairman's report*		Supplementary statements
Summary of financial results*		C&AG's Comments on Accounts
Financial highlights for a number of years*		(Government Companies)
Director's report		Audited consolidated financial statements
Management Discussion & Analysis		Information on human resources*
Corporate governance report		Value added statement*
Auditor's report on financial statements		Corporate social reponsibility report*
Balance sheet		Environmental on Brand/ Intangibles*
Statement of Profit and Loss		EVA® report*
Significant accounting policies		Business Responsibility
Schedules and notes to accounts		Reports with * are provided voluntarily

*Regarding last few items disclosure is limited to large companies only.

CHAPTER 4

The Companies Act, 2013

The Companies Act is administered by the Ministry of Corporate Affairs (MCA), Government of India. The main functionaries are Registrars and Liquidators. At the end of 2014, there were 15 Registrars and 14 Liquidators. Another 9 Officials are functioning both as Registrar and Liquidator. Regional Directors at seven locations exercise supervision over them.

Registrars register the companies and ensure that such companies comply with statutory requirements under the Act. They inspect the books of accounts and other documents to ascertain whether they are resorting to illegal/ fraudulent practices that may adversely affect the interests of shareholders, creditors, employees and others. If necessary, action is initiated for investigation /special audit under provisions of the Act followed by prosecution.

Liquidators deal with winding up affairs of the companies. They function under the directions and supervision of the High Courts though remain under the overall administrative control of MCA. Liquidators file claims against debtors for realisation of debts due to the company, take possession of movable and immovable assets of the company, organise for sale, and adjudicate claims of creditors, payments to them. They deal with instituting criminal complaints and misfeasance proceedings against former Directors for acts and omissions and breach of trust.

A total of 9.5 lakh companies were registered by the end of March 2014. In the year 2013-14 a total of 98,437 companies were registered with collective authorised capital of ₹ 38,874 crore. Out of these 98,374 were Non-Government companies with authorized capital of ₹ 23,566 crore and 63 were Government companies with authorized capital of ₹ 15,307 crore. A total number of 4,051 foreign companies were registered in the country and of them 3,240 foreign companies were active. During the financial year 2013-14 a total of 216 foreign companies were registered.

Economic Sector-wise composition of active companies as on 31.3.2014						
				(Authorised Capital in ₹ Crore)		
	Private		Public		Total	
Economic Activity	**Number of Companies**	**Authorised Capital**	**Number of Companies**	**Authorised Capital**	**Number of Companies**	**Authorised Capital**
Agriculture & Allied	21,271	14,413	2,845	32,435	24,116	46,848
Industry	304,375	644,679	25,697	15,75,675	330,072	22,20,354
Manufacturing	185,432	344,311	17,897	611,668	203,329	955,979
Construction	97,388	171,329	5,336	194,475	102,724	365,804
Electricity, Gas, water Supply	10,937	104,093	1,722	712,860	12,659	816,953
Mining & Quarrying	10,618	24,947	742	56,672	11,360	81,619
Service	524,194	555,367	30,567	830,178	554,761	13,85,545
Business Services	194,934	151,163	6,961	219,759	201,895	370,922
Trading	138,619	121,777	6,212	99,394	144,831	221,171
Finance, Insurance & Real Estate	104,820	192,085	12,113	269,673	116,933	461,758
Community, Social Services etc.	56,777	50,682	3,833	111,374	60,610	162,056
Transport, Storage & Communications	29,044	39,660	1,448	129,979	30,492	169,639
Unclassified	38,590	84,669	4,894	250,116	43,484	334,785
Total	888,430	12,99,128	64,003	26,88,404	952,433	39,87,532

Out of the companies which came out with Initial Public Offerings (IPOs) during 1992-2005, 238 companies were identified as ‘vanishing companies. The number stood at 81 at the end of 2013. The breakup of companies at work (limited by shares) at the end of March 2013 (public limited/private limited; government/ non-government was as follows.

(a) Government Companies	**1381**
(i) Public Limited	1039
(ii) Private Limited	342
(b) Non-Government Companies	**882230**
(i) Public Limited	63791
(ii) Private Limited	818439
Total (a+b)	**883611**
Companies with Unlimited Liability	431
Companies Limited by Guarantee and Associations not for profit	4242
Foreign Companies	2554
Grand Total	**8,90,838**

In India, about 95% of industrial units are micro, small and medium enterprises (MSMEs). It is estimated that about 3 to 4 crore such units exist (mostly unregistered). They contribute 7 to 8% of GDP and provide employment to about 8 to 10 crore. Most of them, perhaps more than 95% are not registered. Among those registered it was found that 90% are registered as proprietorships, 7 % as partnerships, 3% cooperative and less than 1% as companies. It was estimated that about 45% in rural areas and 40% of the MSMEs do not use electricity.

To facilitate these entities Parliament enacted the Limited Liability Partnership Act, 2008. MCA reports state that during 2009-2013 about 20,000 LLPs were registered of which 75% are in service sector. LLP contains elements of both 'a corporate structure' as well as 'a partnership firm structure' LLP is called a hybrid between a company and a partnership.

For the purposes of registration the word "company" in the Act includes any partnership firm, limited liability partnership, cooperative society, society or any other business entity formed under any other law for the time being in force.

The Act introduces a new type of entity to the existing list (public or private limited company) by enabling the formation of a new entity 'one-person company'. An OPC means a company with only one person as its member [Section 3(1)].

The Companies Act 2013 contains 470 Sections organized into 29 chapters and 7 Schedules. Ministry of Corporate Affairs notifies the Rules to operationalise the Sections of the Act. By the end of 2014, it notified several Rules.

Chapter I	Preliminary (includes definitions)
Chapter II	Incorporation of Company (Section 3 to 22)
Chapter III	Prospectus and allotment of Securities (23-42)
Chapter IV	Share Capital and Debentures (43-72)
Chapter V	Acceptance of Deposits by Companies (73-76)
Chapter VI	Registration of Charges (77-87)
Chapter VII	Management and Administration (88-122)
Chapter VIII	Declaration and payment of Dividend (123-127)
Chapter IX	Accounts of the Companies (128-138)
Chapter X	Audit and Auditors (139-148)
Chapter XI	Directors (149-172)
Chapter XII	Meetings of Board and its Powers (173-195)
Chapter XIII	Appointment & Remuneration of Management Personnel (195-205)
Chapter XIV	Inspection, Inquiry and Investigation (206-229)
Chapter XV	Compromises, Arrangements and Amalgamations (230-240)
Chapter XVI	Prevention of Oppression and Mismanagement (241-246)

Chapter XVII	Registered Valuers (247)
Chapter XVIII	Removal of names of companies from the Register (248-252)
Chapter XIX	Revival and Rehabilitation of Sick Companies (253-269)
Chapter XX	Winding Up of Company (270-365)
Chapter XXI	Companies authorised to Register under the Act (366-378)
Chapter XXII	Companies incorporated outside India (379-393)
Chapter XXIII	Government Companies (394-395)
Chapter XXIV	Registration Offices and Fee (396-404)
Chapter XXV	Companies to furnish information or statistics (405)
Chapter XXVI	Nidhis- Nidhi Companies (406)
Chapter XXVII	National Company Law Tribunal and Appellate Tribunal (407-434)
Chapter XXVIII	Special Courts (435-446)
Chapter XXIX	Miscellaneous (447)
Schedule I	Memorandum of Association
Schedule II	Useful lives to compute Depreciation
Schedule III	Instructions for preparation of Balance Sheet Profit and Loss
Schedule IV	Code of conduct for independent directors
Schedule V	Appointing whole time Managing Director or Manager without approval of Government
Schedule VI	Infrastructure projects
Schedule VII	Activities under corporate social responsibility

Some of important definitions in the Act are given below

Company means a company incorporated under this Act or under any previous company law. A company may be a public company or a private company. A company may be an unlimited company or a company limited by shares or by guarantee.

Where a company to be formed is to be a public company, it has to be by seven or more persons. Where the company to be formed is to be a private company, it has to be by two or more persons. One Person Company means a company which has only one person as a member. A company formed may be either a company limited by shares; or a company limited by guarantee; or an unlimited company. The memorandum of a company shall state the name of the company with the last word Limited in the case of a public limited company, or private limited in the case of a private limited company.

A company may be formed by persons (subject to restrictions of minimum number of persons indicated above) for any lawful purpose by subscribing their names or his name to a memorandum and complying with the requirements of this Act in respect of registration. For registration and incorporation of the company the memorandum and articles of the company duly signed by all the subscribers to the memorandum in such manner as prescribed should be filed with the Registrar (of the jurisdiction). The articles of a company shall contain the regulations for management of the company.

Public Company means a company that has a minimum paid-up share capital of five lakh rupees or such higher paid-up capital, as may be prescribed. (A company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles).

Private Company means a company having a minimum paid-up share capital of one lakh rupees or such higher paid-up share capital as may be prescribed, and which by its articles, (*i*) restricts the right to transfer its shares; (*ii*) except in case of one person company, limits the number of its members to two hundred and (*iii*) prohibits any invitation to the public to subscribe for any securities of the company.

Government Company means any company in which not less than fifty-one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company;

Body Corporate or Corporation includes a company incorporated outside India, but does not include (as notified by Government of India) (*i*) a co-operative society registered under any law relating to co-operative societies; and (*ii*) any other body corporate (not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf.

Small Company means a company, other than a public company, (*i*) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; or (*ii*) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees. (Nothing in this clause shall apply to a holding company or a subsidiary company, a company registered under Section 8; or a company or body corporate governed by any special Act).

Unlimited Company means a company not having any limit on the liability of its members.

Limited Company offers limited liability to its members. The company (as a separate legal entity) is liable for its debts and the members and directors are not personally liable (unless they have acted wrongly in some way). The members' liability is limited to paying to the company the amount they have agreed to pay for their shares. The members of a company limited by guarantee are bound by a guarantee in the Companies memorandum of association requiring them to pay the Companies debts up to a fixed sum, Company Limited by Shares means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them.

Company limited by Guarantee means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

Listed Company means a company which has any of its securities listed on any recognised stock exchange.

Holding Company in relation to one or more other companies, means a company of which such companies are subsidiary companies;

Associate Company, in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company. (Significant influence means control of at least twenty per cent of total share capital, or of business decisions under an agreement)

Banking Company means a banking company as defined in clause (*c*) of Section 5 of the Banking Regulation Act, 1949.

Subsidiary Company or subsidiary, in relation to any other company (that is to say the holding company), means a company in which the holding company (*i*) controls the composition of the Board of Directors; or (*ii*) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies. (Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed).

Holding Company in relation to one or more other companies, means a company of which such companies are subsidiary companies.

Foreign Company means any company or body corporate incorporated outside India which has a place of business in India whether by itself or through an agent, physically or through electronic mode; and conducts any business activity in India in any other manner.

Promoter means a person (*a*) who has been named as such in a prospectus or is identified by the company in the annual return referred to in Section 92; or (*b*) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or (*c*) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act (shall apply to a person who is acting merely in a professional capacity).

Financial Institution includes a scheduled bank, and any other financial institution defined or notified under the Reserve Bank of India Act, 1934;

Public Financial Institution means (*i*) the Life Insurance Corporation of India (*ii*) the Infrastructure Development Finance Company Limited, (*iii*) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002; and *(iv)* institutions as may be notified by the Central Government in consultation with the Reserve Bank of India. (No institution shall be so notified unless it has been established or constituted by or under any Central or State Act; or not less than fifty-one per cent of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments.)

Charitable Trusts are the ones where a person or association of person are registered (subject to complying with provisions of Section 8) as a limited company (without addition to its name limited or private limited) for the purpose of promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object. It needs to apply its profits, if any, or other income in promoting its objects; and prohibit the payment of any dividend to its members.

Dormant Company is a company is formed and registered for a future project or to hold an asset or intellectual property and has not significant accounting transactions. It need to obtain such status in the prescribed manner.

Authorised Capital or nominal capital means such capital as is authorized by the memorandum of a company to be the maximum amount of share capital of the company.

Share means a share in the share capital of a company and includes stock. The share capital of a company limited by shares shall be of two kinds (a) equity share capital (b) preference share capital. The equity share capital can be (i) with voting rights; or (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.

Called-up capital means such part of the capital, which has been called for payment.

Issued Capital means such capital as the company issues from time to time for subscription.

Subscribed Capital means such part of the capital which is for the time being subscribed by the members of a company.

Paid-up Share Capital or share capital paid-up means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called.

Sweat Equity Shares means such equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

Securities include shares, scripts, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate. Securities include derivatives. (Securities Contracts (Regulation) Act, 1956).

Derivatives include a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security. It can also be a contract which derives its value from the prices or index of prices of underlying securities. (Securities Contracts (Regulation) Act, 1956)

Charge means an interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage.

Turnover means the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year

Net Worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

Free Reserves means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend; provided that—(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or (ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

Board of Directors or Board, in relation to a company, means the collective body of the directors of the company. Director means a director appointed to the Board of a company.

The shareholders (also called members) own the company and they appoint or elect directors to manage it. Depending on the provisions in the Companies Law and Companies Articles of Association; some decisions to be made by the directors in board meetings and others to be made by the shareholders in general meetings and some decisions have to be made by the directors, but only with the shareholders' consent by means of an ordinary or special resolution. Unless the articles say so (and most do not) a director does not need to be a shareholder and a shareholder has no right to be a director.

Key Managerial Personnel in relation to a company, means the Chief Executive Officer or the managing director or the manager; the company secretary; the whole-time director; the Chief Financial Officer and such other officer as may be prescribed.

Managing Director means a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its Board of Directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called. Whole-time director includes a director in the whole-time employment of the company. Chief Executive Officer means an officer of a company, who has been designated as such by it.

Chief Financial Officer means a person appointed as the Chief Financial Officer of a company.

Company Secretary or secretary means a company secretary as defined in the Company Secretaries Act, 1980 who is appointed by a company to perform the functions of a company secretary under this Act.

Cost Accountant means a cost accountant as defined in the Cost and Works Accountants Act, 1959.

Chartered Accountant means a chartered accountant as defined in the Chartered Accountants Act, 1949 who holds a valid certificate of practice.

Books of Account includes *records maintained in respect of* (*i*) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place; (*ii*) all sales and purchases of goods and services by the company; (*iii*) the assets and liabilities of the company; and (*iv*) the items of cost as may be prescribed

Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

Financial Statement in relation to a company, includes (*i*) a balance sheet as at the end of the financial year; (*ii*) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year; (*iii*) cash flow statement for the financial year; (*iv*) a statement of changes in equity, if applicable; and (*v*) any explanatory note annexed to, or forming part of the above. (Financial statement, with respect to one Person Company, small company and dormant company may not include the cash flow statement).

CHAPTER 5

Accounts of the Companies

(Sections 128 to 138 of the Companies Act, 2013)

Books of Accounts

Section 128 of the Act prescribes that every company should prepare books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company. Such books should be kept on accrual basis and according to the double entry system of accounting. It should include branch offices or offices if any and if so, the accounts should explain the transactions affected both at the registered office and its branches. Companies should keep these books of accounts at the registered office. Companies can keep them in other places in India decided by the Board of Directors but the Registrar should be informed of this fact and the full address in writing within seven days. Company may keep such books of account or other relevant papers in electronic mode but in the manner as may be prescribed. Any branch can keep the books of accounts relating to the transactions of branch at the branch office but should periodically send proper summarized returns registered office.

The books of account and other books and papers maintained by the company can be inspected and should be open for inspection by any director at the registered office during business hours. In the case of financial information, if any, maintained outside the country, copies of such financial information should be maintained and produced for inspection.

Company should keep the books of account of last eight financial years, together with the vouchers relevant to any entry in such books of account, in good order. Where an investigation has been ordered the Central Government may direct that the books of account may be kept for such longer period as it may deem fit.

The Managing Director, the whole-time director in charge of finance, the Chief Financial Officer or any other person of a company charged by the Board with the duty of complying with the provisions of this Section, is punishable with imprisonment extending to one year or with fine of fifty thousand rupees to five lakh or with both, if he or she contravenes these provisions. (Section 128(6) of Companies Act 2013)

Financial Statement

Section 129 of the Act prescribed that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified. Central Government prescribes and notifies the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

The financial statements should be in the form or forms as provided for different class or classes of companies in Schedule III. It differentiates the financial statement of the company and 'consolidated financial statement' which includes subsidiaries, associates and joint ventures. Items contained in such financial statements shall be in accordance with the accounting standards.

Where a company has one or more subsidiaries, it should, in addition prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. The word subsidiary includes associate company and joint venture. The parent company holding the subsidiary is called 'holding company'. The provisions of the Companies Act applicable to the preparation, adoption and audit of the financial statements of a holding company, mutatis mutandis, apply to the consolidated financial statements. The company should also attach a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed.

Board of Directors at every annual general body meeting should lay the financial statements for the financial year before such meeting.

Form of financial statement for insurance company, banking company, companies generating or supplying electricity, and some other companies is specified by Acts governing them such as Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999; Banking Regulation Act, 1949; Electricity Act, 2003 etc. The disclosure requirements would be different.

The managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person of a company charged by the Board with the duty of complying with the provisions of this Section, he or she is punishable with imprisonment extending to one year or with fine of fifty thousand rupees to five lakh or with both, if the company contravenes these provisions.

According to Section 120 the documents, records, registers, minutes may be kept and inspected in electronic form. As per Companies (Management and Administration) Rules, 2014, it is mandatory for every listed company or a company having not less than one thousand shareholders, debenture holders and other security holders, to maintain its records, as required to be maintained under the Act or rules made there under, in electronic form.

Financial Statements to be Certified by a Qualified Auditor (Individuals or a Firm)

Section 139 deals with conditions related to appointment of auditor. Section 143 gives the powers to auditors such as access to books of accounts and prescribes the duties related to conduct of audits. Audit report should mention qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company. Otherwise auditor should certify that financial statements are free from any material misstatements. Auditor should sign and certify the audit report. The auditor's report should be read in the general meeting and shall be open to inspection by any member of the company (Section 145). Section 146 says all notices relating to, any general meeting shall be forwarded to the auditor. He should attend either by himself or through his authorised representative and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Financial Statement, Report by the Board of Directors etc.

Section 134 of the Act prescribes that the financial statement, including consolidated financial statement, if any, should be approved by the Board of Directors before they are signed on behalf of the Board. Those who sign should be (i) at least by the chairperson of the company or by two directors out of which one shall be managing director and the Chief Executive Officer (if he is a director in the company) and (ii) the Chief Financial Officer and the (iii) Company Secretary of the company. Only one Director can sign in the case of a One Person Company.

The auditors' report should be attached to every financial statement laid before general meeting. A report by the Board of Directors should also be laid which should include:

Annual return in the prescribed form containing the following particulars as they stood on the close of the financial year:

Principal business activities, particulars of its holding, subsidiary and associate companies; its shares, debentures and other securities and shareholding pattern; its indebtedness; its members and debenture-holders along with changes therein since the close of the previous financial year; its promoters, directors, key managerial personnel along with changes therein since the close of the previous financial year; remuneration of directors and key managerial personnel; penalty or punishment imposed on the company, its directors or officers; matters relating to certification of compliances, disclosures; details, in respect of shares held by or on behalf of the Foreign Institutional Investors

Number of meetings of the Board

Directors Responsibility Statement which should state that:

(a) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(b) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(c) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(d) the directors had prepared the annual accounts on a going concern basis; and

(e) the directors, in the case of a listed company, had laid down 'internal financial controls'[5] to be followed by the company and that such internal financial controls are adequate and were operating effectively.

(f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

A statement on declaration given by independent directors which says that:

He or she is or was not a promoter of the company (that includes its holding, subsidiary or associate company) not related to a promoter; has or had any pecuniary relationship during preceding two year and current financial year; neither himself nor any of his relatives holds or has held the position of a key managerial personnel or is or has been employee of the company in any of the three preceding years in which he or she is appointed. Also about their remuneration. [147, 178]

Particulars of loans, guarantees or investments

Section 186 prescribes certain conditions for giving loan or guarantee or making investment. For example should not make investment through not more than two layers of investment companies with some exceptions.

Particulars of contracts or arrangements with related parties in the prescribed form

Section 188 prohibits entering into any contract or arrangement with a related party with respect to selling, leasing, disposing, buying property of any kind; sale, purchase or supply of any goods or materials; availing or rendering of any services etc., with some exceptions.

The amounts, if any, which it proposes to carry to any reserves

The amount, if any, which it recommends should be paid by way of dividend

Material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report

5 For the purposes of this clause, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to Companies policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

The conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed;

A statement on development and implementation of a risk management policy

Details about the policy developed and implemented by the company on corporate social responsibility initiatives taken during the year

The above mentioned report by the Board of Directors any annexures should be signed like the financial statements.

A signed copy of every financial statement, including consolidated financial statement, should be issued, circulated or published along with a copy each of (a) any notes annexed to or forming part of such financial statement; (b) the auditor's report; and (c) the Board's report.

If a company contravenes the provisions of this Section, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both. {Section 134 (8)}.

Right of member to copies of audited financial statement

Under Section 136, every company shall in each year hold in addition to any other meetings, a general meeting as its annual general meeting by giving not less than clear twenty-one days' notice. Company should send a copy of financial statement, auditor report and other reports documents to every member of the company (and to other persons so entitled) not less than twenty-one days before the date of meeting. For each subsidiary there should be separate audited accounts.

In the case of listed companies, if the copies of the documents are made available for inspection at its registered office during working hours for a period of twenty-one days before the date of the meeting, but a statement of salient features in the documents are sent to them, it is deemed to have been provided. However, the shareholders may ask for full financial statements.

A listed company shall also place its financial statements including consolidated financial statements, if any, (separate audited accounts in respect of each subsidiary) and all other documents required to be attached thereto, on its website, which is maintained by or on behalf of the company.

Noncompliance to this Section invites a penalty of twenty-five thousand rupees for the company and five thousand for each officer involved.

Copy of Financial Statement to be filed with Registrar

Section 137 prescribes that a copy of the financial statements with all the documents which are required to be attached to such financial statements, duly adopted at the annual general meeting of the company, should be filed with the Registrar within thirty days of the date of annual general meeting. If they are not adopted in that annual general meeting for any reason, they should be filed as provisional records, followed by the adopted ones subsequently. Accounts of subsidiaries outside India, if any, are also required to be attached to the Financial statements of the Company filed with the Registrar.

If annual general meeting for the year was not held for any reason the said documents, along with the statement of facts and reasons for not holding should be filed with the Registrar within thirty days from the date the meeting should have been held. Noncompliance with these rules would invite fine of one thousand for every day, imprisonment up to six months and penalty from rupees one lakh to five lakh.

A One Person Company should file a copy of the financial statements adopted by its member within one hundred eighty days from the closure of the financial year.

Revision of Financial Statements or Board's report

Section 131 provides that if it appears to the directors of a company that the financial statement of the company or the report of the Board did not comply with the provisions of the Act, they can prepare revised ones for any of the three preceding financial years. They need to seek and obtain the approval of the Tribunal in the prescribed form and manner. Tribunal issues notice to the Central Government and the Income Tax authorities and takes into consideration the representations, if any, made by them before passing any order. Company needs to file this approval order with the Register. The revised statements should go through the process detailed above.

Section 130 provides that Central Government, the Income-Tax authorities, the Securities and Exchange Board, any other statutory regulatory body or authority can approach the Tribunal or a Court of competent jurisdiction for seeking to re-open the accounts if they have reasonable evidence that the earlier accounts were prepared in fraudulent manner or affairs were mismanaged casting a doubt on the reliability of financial statements. The accounts so revised or recast subsequent to the orders of the Tribunal, are be treated as final.

Internal Audit and Audit Committee

Internal Audit (Section 138) functioning under an Audit Committee (Section 177) at the Board level also provides assurance of the reliability of the accounts and financial statements. Section 177 provides for Audit Committee for every listed company. It should consist of a minimum of three directors with independent directors forming majority. Chartered Accountant or a cost accountant, or such other professional would be internal auditors.

Enforcement of Application of the prescribed Accounting Standards

Under Section 132, National Financial Reporting Authority (NFRA), which is yet to be created by the Central Government, is entrusted with powers to monitor and enforce the compliance with accounting standards applicable in the preparation of financial statements and auditing standards for conducting the audit.

CHAPTER 6

Accounting Standards

Accounting Standards are the written policy documents that provide framework of norms covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements. The purpose of accounting standards is to have uniformity in financial reporting of the entities and thus make the financial reports consistent and comparable.

Accounting differences cause problem in valuation and thus in the decision making process. When a multinational company (MNC) has to report under the standards of both the countries it might lead to some extremely odd results. For instance, Daimler Benz, who was the first German to secure stock market listing in the United States, reported a net profit of DM 158 m for the six months to June 1998 based on German GAAP. The U.S GAAP reconciliation statement revealed that the company had incurred a loss of DM. 949m. Similarly, British Telecom Inc. reported a net profit of £1767 for the year ended 31-3-1994 under the UK GAAP but under the US GAAP reconciliation- the net profit reduced to £1476.

Historically a set of accounting standards evolved in each country to meets the requirements of financial reporting in that country. They are referred to as Generally Accepted Accounting Principles (GAAP). For example UK has its own GAAP and USA has its own GAAP. India has also its own GAAP. To a large extent they are similar across the countries but differences exist. Need for international standards was felt particularly with growing number of MNCs. A set of such standards emerged which are referred to as International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). A number of countries have already adopted them and the remaining are in the process of adopting them.

Indian Accounting Standards - Generally Accepted Accounting Principles (GAAP)

Institute of Chartered Accountants of India (ICAI) created under an Act of the Parliament, Chartered Accountants Act, 1949 has been traditionally engaged in setting the accounting standards in India. Up to 1997 there was no statutory backing of accounting standards in

India. ICAI pursued it as a professional requirement by ensuring compliance of accounting standards through audit functions by its members. ICAI standards of accounting were viewed as deemed standards till such standards are officially prescribed by the Central Government.

Companies (Amendment) Ordinance 1998 and related amendment to the Companies Act 1956 gave statutory recognition to accounting standards and required the auditors to report on the compliance with the accounting standards. This ordinance also provided for the constitution of National Advisory Committee on Accounting Standards (NACAS).

Section 133 of the Companies Act 2013 states that the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under Section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA). As of now NACAS continues to perform the role of NFRA pending its creation. A number of standards are formally issued by the Central Government (Ministry of Corporate Affairs) in consultation with NACAS which in practice improves upon the text prepared by ICAI.

At the top of the organisation structure is the Council of the ICAI. It is assisted by Accounting Standard Board (ASB) for preparing the Accounting Standards (AS). The composition of the ASB is broad based to ensure due representations and the participation of all those who are interested in the formulation and implementation of these standards. Apart from the elected members of the Council of the ICAI nominated on the ASB, there are various Central Government nominees, nominees from various other professional institutes like the Institute of Cost Accountants of India, Institute of Company Secretaries of India, Representatives of Industry Associations, Reserve Bank of India, Securities and Exchange Board of India, Controller General of Accounts, Central Board of Excise and Customs, Representative of Academic and Financial Institutions, other eminent professionals co-opted by the ICAI and any representative (s) of other body, as considered appropriate by the ICAI.

The drafts prepared are sent to various outside bodies like FICCI, ASSOCHAM, SCOPE, C&AG, ICAI, ICSI, CBDT etc. After taking into consideration their views, the draft of the standard is issued as an Exposure Draft (ED) for comments by members of ICAI and the public at large. The comments on the ED are considered by ASB and a final draft of the standard is submitted to the Council of the ICAI for its approval. Subsequently they are considered by NACAS and the Central Government.

Reserve Bank of India (RBI) pronounces policies which are specific to banks, financial institutions, and finance companies. Securities & Exchange Board of India (SEBI) being an important regulatory body also issues guidance on specific issues. Foreign Exchange Dealers Association (FEDAI) provides guidelines regarding accounting for foreign exchange transactions. The Income Tax law includes specific rules to meet taxation requirements like for example computing income under the ‘Profits & Gains of Business or Profession’.

Applicability of Accounting Standards

The Accounting Standard should be applied in preparation of ‘General Purpose Financial Statements’ which includes Balance Sheet, Profit & Loss Account, Cash Flow Statement, Schedules, and other statements and explanatory notes. Every company and its auditor(s) should comply with the Accounting Standards. However, Government granted certain relaxations to the Small and Medium Enterprises (SMEs).

Following is the list of Accounting Standards.

AS 1	Disclosure of Accounting Policies	01-04-1993
AS 2	Valuation of Inventories (Revised)	01-04-1999
AS 3	Cash Flow Statement (Revised)	01-04-2001
AS 4	Contingencies & Events Occurring after Balance Sheet Date	01-04-1998
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)	01-04-1996
AS 6	Depreciation Accounting (Revised)	01-04-1995
AS 7	Construction Contracts (Revised)	01-04-2002
AS 8	Research & Development	(Now in AS 26)
AS 9	Revenue Recognition	01-04-1993
AS 10	Accounting for Fixed Assets	01-04-1993
AS 11	The Effects of Changes in Foreign Exchange Rates (Revised)	01-04-2004
AS 12	Accounting for Government Grants	01-04-1994
AS 13	Accounting for Investments	01-04-1995
AS 14	Accounting for Amalgamations	01-04-1995
AS 15	Employee Benefits	01-04-2006
AS 16	Borrowing Costs	01-04-2000
AS 17	Segment Reporting	01-04-2001
AS 18	Related Party Disclosures	01-04-2001
AS 19	Leases	01-04-2001
AS 20	Earnings Per Share	01-04-2001
AS 21	Consolidated Financial Statement	01-04-2001
AS 22	Accounting for Taxes on Income	01-04-2006
AS 23	Accounting for Investment in Associates in Consolidated Financial Statements	01-04-2002
AS 24	Discontinuing Operations	01-04-2004
AS 25	Interim Financial Reporting	01-04-2002

AS 26	Intangible Assets	01-04-2003
AS 27	Financial Reporting of Interests in Joint Ventures	01-04-2002
AS 28	Impairment of Assets	01-04-2008
AS 29	Provisions, Contingent Liabilities and Contingent Assets	
AS 30	Financial Instruments: Recognition and Measurement (Recommendatory)	
AS 31	Financial Instruments: Presentation (Recommendatory)	
AS 32	Financial Instruments: Disclosure (Recommendatory)	

Some of the Accounting Standards as prescribed in syllaus are explained in the subsequent chapters.

AS 1: DISCLOSURE OF ACCOUNTING POLICIES

This standard deals with disclosure of significant accounting policies followed in the preparation and presentation of the financial statements and is mandatory in nature. The accounting policies refer to the specific accounting principles adopted by the enterprise. Proper disclosure would ensure meaningful comparison both inter/intra enterprise and also enable the users to properly appreciate the financial statements. Financial statements are intended to present a fair reflection of the financial position, financial performance and cash flows of an enterprise. Irrespective of the standardisation, diversity in accounting policies is unavoidable for the reasons that companies work in diverse situations and therefore it is impossible to develop single set of policies applicable to all the companies for all time and accounting standards cannot and do not cover all possible areas of accounting and companies have freedom of adopting any reasonable accounting policy in areas not covered by standards.

Following are the areas involving different accounting policies by different enterprises (the list is not exhaustive)

- Methods of depreciation, depletion and amortization
- Treatment of expenditure during construction
- Treatment of foreign currency conversion/translation, Valuation of inventories
- Treatment of intangible assets
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities

The primary consideration in the selection of accounting policies by companies is that financial statements prepared on the basis of such policies should represent ***'true and fair'*** view of the affairs of company. To ensure ***'true and fair'*** view the accounting policies so selected should be based on Prudence, Substance over form and Materiality.

Prudence

Prudence means making of estimates, which is required under conditions of uncertainty. In view of the uncertainty attached to the future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provisions made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

For example if valuation of stock is always done at cost, consider a situation where market price of the relevant goods has reduced below the cost price, then valuing stock at cost price means ignoring anticipated losses. Similarly if stock is always valued at market price, then take a situation where cost price is below market price, indirectly we are recognising the anticipated gross profit on stock in the books. Therefore, accounting policy should be cost price or market price whichever is less, in this case we are ignoring anticipated profit (if any) but providing for any anticipated losses.

Substance over form

It means that transaction should be accounted for in accordance with actual happening and economic reality of the transactions, i.e. events governed by substance and not merely by the legal form. For example: The ownership of an asset purchased on Hire purchase is not transferred till the payment of the last instalment is made but the asset is shown in the books of the hire purchaser.

Materiality

The financial statements should disclose all the 'Material 'items' i.e items the knowledge of which might influence the decision of the user of the financial statement. The materiality of an item is decided on the basis that whether non-disclosure of the item will affect the decision making of the user of the accounts, If the answer is positive then the item is material and should be disclosed, in case answer is negative, item is immaterial. By this statement does not mean that immaterial item should not be disclosed, disclosure or non-disclosure of an immaterial item is left at the discretion of the accounts but disclosure of material item is mandatory.

For Example any penalty paid by the enterprise should be disclosed separately even though the amount paid is negligible, similarly payment of tax also should be disclosed separately and not to be merged with office expenses or misc. expenses.

AS-1 requires that all "significant" accounting policies adopted in the preparation and presentation of financial statements, should be disclosed by way of 'Note in one place as the note No 1'.

Changes in Accounting Policies

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in the later period should be disclosed. In the case of a change in accounting policies, having material effect in the current period, the amount by which any item in the financial statements, is affected by such change should also be disclosed to the extent ascertainable, otherwise the fact that the effect is not (wholly or partially) ascertainable, should be disclosed.

Certain basic assumptions viz., ***Going Concern, Consistency and Accrual,*** in the preparation of financial statements are accepted and their use are assumed, no separate disclosure is required except for non-compliance in respect thereof.

Illustration-1

1. A ltd. has sold its building for ₹ 50 Lakhs to B Ltd. And has also given the possession to B ltd. The book value of the building is ₹ 30 Lakhs. As on 31st March 2012 the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Comment.

Solution:

The economic reality and substance of the transaction is that the right and beneficial interest in the property has been transferred, although legal title has not been transferred. A Ltd. should record the sale and recognise the profit of ₹ 20 Lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

Illustration-2

Compensation payable to employees under voluntary retirement scheme has been deferred to be written off over a period of four years as against the past practice of charging out the same on payment/due basis. Comment.

Solution:

Since company is deviating from the past practices of charging on payment/due basis, the reason for change in policy must be incorporated with notes to accounts.

AS 2: VALUATION OF INVENTORIES

Though appears to be inventory in common parlance, AS-2 excludes the following.

(a) Work-in-progress arsing under construction contract including directly related service contract,

(b) Work-in-progress arising in the ordinary course of business of service providers,

(c) Shares, debentures and other financial instruments held as stock-in-trade and

(d) Livestock, agricultural and forest product, mineral oil/gasses as measured at net realizable value as per trade practices at certain stage of production.

AS-2 covers inventories as an item of assets which are:

(a) held for sale in the ordinary course of business

(b) in the process of production for such sale

(c) in the form of material or supplies for the process of production or rendering of service

Inventories are valued at lower of cost or net realizable value (NRV). Cost to include purchase price, conversion and other costs incurred in bringing the inventories to their present location and condition. The cost of inventories should be assigned by using the specific cost, FIFO, weighted average, standard cost, adjusted selling price formula. Net realizable value is the estimated selling price in the ordinary course of business reduced by the estimated cost to bring the item in saleable condition. When we say that the stock should be valued at the lower of the Cost or Net Realisable Value, one should note that only under two circumstances cost of inventories will surpass its net realisable value:

- The goods damaged or obsolete and not expected to realise the normal sale price.
- The cost necessary for the production of goods has gone up by greater degree.
- Both the above cases we don't expect in the normal functioning of the business, hence whenever it is found that goods are valued at NRV, care should be taken to study the existing market position of the relevant products.

AS-2 requires that financial statements should disclose the:

(a) the accounting policy adopted in measuring inventories including

(b) the cost formula used

(c) carrying amount (value) of inventory commonly classified under Raw Material and Components, Work in Progress, Finished goods and Stores, Spares and Loose tools.

(d) Schedule-III and AS-2 disclosure are at par.

Illustration 1

Raw materials purchased at ₹ 10 per kg price of materials is on the decline. The finished goods in which the raw material is incorporated are expected to be sold at below cost. 1,000 kgs of raw material is in stock at the year-end. Replacement cost is ₹ 8 per kg. How will you value the inventory?

Solution:

As per para 24 of AS-2, on valuation of inventories, material and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there is a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

Hence, the value of stock of 1,000 kg of raw materials will be valued at ₹ 8 per kg. The finished stock should be valued at cost or net realizable value, whichever

Illustration 2

Cost of Production of product A is given below:

Raw material per unit	₹ 150
Wages per unit	₹ 50
Overhead per unit	₹ 50
	₹ 250

As on the balance sheet date the replacement cost of raw material is ₹110 per unit. There are 100 units of raw material on 31.3.12.

Calculate the value of closing stock of raw materials in the following conditions:

(i) If finished product is sold at ₹ 275 per unit, what will be the value of closing stock of raw material?

(ii) If finished product is sold at ₹ 230 per unit, what will be the value of closing stock of raw material?

Solution:

(i) The realizable value of the product is more than the total cost of the product. The cost of raw material per unit is more than the replacement cost, hence, raw materials should be valued on actual cost.

Therefore, the value of raw materials: 100 units x ₹ 150 per unit= ₹15,000

(iii) The realizable value of the product is less than the total cost of the product. Though the cost of raw material per unit is more than the replacement cost, hence, raw materials should be valued on replacement cost.

Therefore, the value of raw materials: 100 units x ₹110 per unit= ₹ 11,000 is lower.

AS 6 (REVISED): **DEPRECIATION ACCOUNTING**

Deprecation is a measure of the wearing out, consumption or other loss of value of a depreciable asset due to use, efflux of time or obsolescence through technology and market changes and also includes amortization of assets having predetermined life. Different accounting policies are followed by different enterprises; hence disclosure is necessary to appreciate the view presented in the financial statements. The revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature.

Depreciation has a significant effect in determining and presenting financial position and operating results. Depreciable asset are those which:

a) Are expected to be used for more than one accounting period

b) Have limited useful life. Land is not subject to depreciation as the useful life of land cannot be determined, it is endless.

c) Are held for use in the production or supply of goods and services, for rental, for administrative purposes, and not for sale in the ordinary course of business.

Following categories of assets are excluded from application of this standard (AS-6)

1. Forest, plantation and similar regenerative resource
2. Wasting asset, expenditure including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources.
3. R&D expenditure
4. Goodwill
5. Livestock: Cattle, Animal Husbandry

The amount of depreciation to be charged in an accounting period is usually based on three factors:

(i) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued.

(ii) Expected useful life of the asset.

(iii) Estimated residual value of the depreciable asset.

The useful life of the depreciable asset is shorter than its physical life. Useful life is either; the period over which a depreciable asset is expected to be used by the enterprise: or the number of production or similar units to be obtained from the use of the asset. Useful life depends upon:

(i) Predetermined by legal or contractual limits (assets given on lease, the estimated life is period of lease)

(ii) Directly governed by extraction or consumption;

(iii) The extent of use and physical deterioration on account of wear and tear;

(iv) Reduced by obsolescence.

(v) Repair and maintenance policy

(vi) Legal or other restrictions.

As per AS-6 any addition or extension to an existing asset which is of capital nature and which becomes an integral part of existing asset is depreciated over the remaining useful life of that asset. Any addition or extension which retains a separate entity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life. For example: in case of replacement of engine of an aircraft, the life of engine is not dependent on the life of the aircraft body, depreciation charged on both can be recorded separately.

Depreciable assets which do not have material value are fully depreciated in the accounting period in which they are required.

The method of depreciation followed by an enterprise is applied consistently, to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. A change in the method of charging depreciation is treated as a change in an accounting policy and is disclosed accordingly

If a depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

When the change is adopted, the depreciation is reworked with reference to the date of the asset put to use by the enterprise; the deficiency/surplus is adjusted in the Profir & Loss Account in the year of change given effect with appropriate disclosure since as per AS 6. This is considered as a change in the Accounting Policy.

This standard requires the company to disclose in its financial statements:

1) The method of charging the depreciation used i.e. SLM, WDV etc.
2) Total amount of depreciation for each class of assets,
3) The gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies,
4) The Depreciation rate or the useful lives of the assets, if they differ from rates specified in the governing statute.
5) In case the depreciable assets are revalued, the depreciation should be provided as the revalued amount on the estimate of remaining useful life of such assets. Disclosure should be made in the year of revaluation, if the same has a material effect on the amount of depreciation.
6) If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material should be disclosed separately (in contrast with the concept of Block under Income Tax Act 1961)

Illustration 1

Plant has useful life of 10 years. Depreciable amount of ₹ 30 lakhs. The company has charged depreciation under SLM. At the end of the 6th year, the balance useful life was re-estimated at 8 years.

Solution:

The depreciation will be charged from the 7th year: $\frac{30\{(30\ /10)\ X6\}}{8} = 1.5$

Illustration 2

B Ltd. purchased certain plant and machinery for ₹ 50 lakhs. 20% of the cost net of CENVAT credit is the subsidy component to be Realised from a State Government for establishing industry in a backward district. Cost includes excise ₹ 8 lakhs against which CENVAT credit can be claimed. Compute depreciable amount.

Solution:

We shall have to determine the historical cost of the plant and machinery.

Purchase Price	₹ 50 lakhs
Less: Specific Excise duty against which CENVAT is available	₹ 8 lakhs
Original Cost of the machinery for accounting purposes	₹ 42 lakhs
Less: Subsidy @ 20% of ₹ 42 lakhs	₹ 8.4 lakhs
Depreciable Amount	₹ 33.6 lakhs

Note: As CENVAT Credit on Capital Goods can be availed up to 50% in the first year of acquisition and the balance in the next year, an alternative treatment may also be considered.

The original cost of the plant and machinery can be taken at ₹ 50 lakhs and a sum of ₹ 8.4 lakhs can be transferred to deferred income account by way of subsidy reserve. The portion of unavailed CENVAT Credit is also required to be reduced from cost.

AS 7 (REVISED): ACCOUNTING FOR CONSTRUCTION CONTRACTS

This revised standard comes into effect in respect of all contracts entered into during the accounting period commencing on or after 1-4-2003 and is mandatory in nature from that date. This statement should be applied in accounting for construction in the financial statements of contractors. The standard prescribes the accounting treatment of revenue and costs associated with the construction contracts to the accounting period in which the construction work is performed, since the main problem relating to accounting for construction contracts is the allocation of revenues and related costs to accounting periods over the duration of the contract.

A construction contract may be related to the construction of single asset or a number of assets closely, interrelated or interdependent in terms of the scope of the contract. For the purpose of this statement construction contract covers:

a) Contracts for rendering of services directly related to the construction of the asset e.g. service of project-managers, architects etc.
b) Contracts for destruction/restoration of assets and restoration of environment following demolition.
c) Consultancy contracts in project management, designing, computers where such contracts are related to the construction of the asset.

A construction contract may be a fixed-price contract (with/without escalation), a cost-plus contract (provision for reimbursement of overhead on agreed basis in addition to fixed price/fees) or a mix of both (a cost-plus contract with a minimum agreed price)

The statement usually apply to each contract separately, however, sometimes it is necessary to apply the statement to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance. When a contract covers a number of assets the construction of each asset should be treated a construction contract when:

- Separate proposal have been submitted for each asset;
- Each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- The costs and revenue of each asset can be separately identified.

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

- The group of construction contract is negotiated as a single package
- The contracts are so closely interrelated that they are in effect, part of a single project with an overall profit margin and
- The contracts are performed concurrently or in continuous sequence.

A construction contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when: (a) The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or (b) The price of the asset is negotiated without regard to the original contract price.

Contract Costs Comprise of Costs:

(a) Directly related to specific contract *(e.g. site labour cost, cost of material, deprecation of plant & Machinery, Cost of moving plant, Cost of hiring plant, cost of design & technical assistance, the estimated cost of rectification and guarantee work, claims from third parties etc.)*

(b) Attributable cost relating to contract activity in general and precisely allocable to the contract as reduced by incidental income not included in contract revenue (sale of surplus material, disposal of contract specific plants etc.). Insurance; Costs of design and technical assistance that are not directly related to a specific contract; and Construction overheads, borrowing costs capitalized under AS 16

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include: (a) General administration costs for which reimbursement is not specified in the contract; (b) Selling costs; (c) Research and development costs for which reimbursement is not specified in the contract; and (d) Depreciation of idle plant and equipment that is not used on a particular contract.

Contract Revenue Comprises of:

(a) The initial amount of revenue agreed in the construction contract; and

(b) Variations in contract work, claims and incentive payments:

- (i) To the extent that it is probable that they will result in revenue; and
- (ii) They are capable of being reliably measured.

Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved.

Contract cost and revenue are recognized for accounting only when the outcome of the construction contract can be measured reliably with regard to the stage of completion of the contracts activity at its B/S date. All expected losses should be recognized as an expense for the contract.

In accounting for construction contracts in financial statements, either the percentage of completion method or the completed contract method may be used. When a contractor uses a particular method of accounting for a contract, then the same method should be followed for all other contracts which meet similar criteria.

This standard requires that an enterprise should disclose:

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

(b) The methods used to determine the contract revenue recognised in the period;

(c) The methods used to determine the stage of completion of contracts in progress.

An enterprise should also disclose for contracts in progress at the reporting date: (a) the aggregate amount of costs incurred and recognized profits (less recognized losses) up to the reporting date; (b) amount of advances received; and (c) the amount of retentions.

'Retentions' are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Retentions are recognized as receivables in the balance sheet of the contractor. An enterprise should present:

(a) The gross amount due from customers for contract work as an asset; and

(b) The gross amount due to customers for contract work as a liability.

Advances are recognized as liabilities until the related revenue is earned.

AS 9: REVENEUE RECOGNITION

AS-9 deals with bases for recognition of revenue in the statement of profit and loss of an enterprise. The standard is concerned with the recognition of revenue arising in the course of ordinary activities of the enterprise form the sale of goods, the rendering of the services and the use by others of enterprise resources yielding interest, royalties and dividends. This standard does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts.

(ii) Revenue arising from hire-purchase and lease agreements.

(iii) Revenue arising from government grants and other similar subsidies.

(iv) Revenue of insurance companies arising from insurance contracts.

As per AS-9, following items are not included within the definition of revenue:

(i) Realised gains resulting from the disposal of fixed assets and unrealised gains resulting from the holding of fixed assets by appreciation in their values.

(ii) Unrealised holding gains resulting from the change in the value of current assets and the natural increases in herds and agriculture and forest products.

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustment arising on the conversion of foreign currency financial statements.

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount.

(v) Unrealised holding gains resulting from the restatement of the carrying amount of an obligation.

Revenue from sales transactions should be recognized only when (i) the seller of goods has transferred to the buyer the property in goods for a certain price and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

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

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. When recognition of revenue is postponed because of the effect of uncertainties, it is considered as revenue of the period in which it is properly recognized.

Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

Disclosure:

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

The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss:

Turnover (Gross)	XXXXX
Less: Excise Duty	XXXXX
Turnover (Net)	XXXXX

The amount of excise duty to be shown as deduction from turnover should be the total excise duty for the year except the excise duty related to the difference between the closing inventory and opening inventory. The excise duty related to the difference between the closing inventory and opening inventory should be recognised separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Illustration 1

The stages of production and sale of a producer are as follows (all in Rupees):

Stage	Activity	Costs to date	Net Realisable Value
A	Raw Materials	10,000	8,000
B	WIP 1	12,000	13,000
C	WIP 2	15,000	19,000
D	Finished Product	17,000	30,000
E	Ready for Sale	17,000	30,000
F	Sale Agreed	17,000	30,000
G	Delivered	18,000	30,000

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

Solution:

According to AS 9, sales will be recognized only following two conditions are satisfied:

(i) The sale value is fixed and determinable.

(ii) Property of the goods is transferred to the customer.

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Net Profit will be determined at Stage G, when goods are delivered and payment becomes due ₹ 12,000 (30,000 – 18,000).

Illustration 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2012.

The details are given below:

Quantity of Gold = 10,000 TT Bars

Gold Rate as on March 31, 2012 = ₹ 275 per TT Bar

Gold Rate was fixed on June 26, 2012 before the finalization of accounts of company = ₹ 273 per TT Bar

Calculate the amount of sales regarding 10,000 TT Bars to be booked in the Companies account for the year ended March 31, 2012.

Solution:

We need to refer to AS 5 along with AS 9; since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at ₹ 273 per TT Bar, gold will be valued at that rate.

Illustration 3

The Board of Directors decided on 31.3.2012 to increase the sale price of certain items retrospectively from 1st January, 2012. In view of this price revision with effect from 1st January 2012, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2012 to 31st March, 2012 and the Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2011-2012.

Solution:

Price revision was effected during the current accounting period 2011-2012. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2012 to 31st March, 2012. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2011-2012 vide Para 10 of AS 9.

Illustration 4

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2011-12. You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution:

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.

(ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 5

A claim lodged with the Railways in March, 2010 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2012 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged.

Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2012.

Solution:

Prudence suggests non-consideration of claim as an asset in anticipation. So receipt of claims is generally recognised on cash basis. Para 9.2 of AS 9 on Revenue Recognition states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. Para 9.5 of AS 9 states that when recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only ₹ 1,50,000 were collected against a claim of ₹ 2,00,000. So this transaction cannot be taken as a Prior Period Item.

It is also suggested to disclose the nature and amount of this item separately as per para 12 of AS 5 (Revised).

Illustration 6

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2011-2012 the company wants to recognise the entire interest receivable. Do you agree?

Solution:

As per para 9.2 of AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

Illustration 7

A Ltd. has sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 2012, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

Solution:

The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred.

A Ltd. should record the sale and recognize the profit of ₹ 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

AS 10: ACCOUNTING FOR FIXED ASSETS

The standard deals with the accounting for tangible fixed assets. The standard does not take into consideration the specialized aspect of accounting for fixed assets reflected with the effects of price escalations but applies to financial statements on historical cost basis. It is important to note that after introduction of AS 16, 19 & 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000. Standard requires an entity to disclose in the financial statements:

(i) Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;

(ii) Expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(iii) Revalued amount substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external value was involved, in case where fixed assets are stated at revalued amount.

This statement does not deal with accounting for the following items to which special considerations apply:

(i) Forests, plantations and similar regenerative natural resources.

(ii) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

(iii) Expenditure on real estate development and

(iv) Biological assets i.e. living animals or plants

The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with this standard. The cost of fixed asset should include its purchase price and any attributable costs of bringing the assets to its working condition for its intended use. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance. Fixed assets should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal. Losses arising from the retirement or gains or losses arising from disposal of fixed asset should be recognised in the profit and loss statement.

When a fixed asset is revalued upward any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement. According to AS-10, an increase in net book value arising on account of revaluation of fixed assets should be credited directly to owners' interest under the head of revaluation reserve, except that, to the extent that such increase is related and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed assets should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized, it may be changed directly to that account.

When several fixed assets are purchased for a consolidated price, the amount paid should be apportioned to the various assets on a fair basis as determined by competent valuers. Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for acquiring it. The direct costs incurred in developing the patents should be capitalized and written off their legal term of validity or over their working life, whichever is shorter.

Self-Constructed Fixed Assets

The cost of a self-constructed asset is determined using the same principles as for an acquired asset The Standard states that if an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing the asset for sale, in accordance with the principles of AS-2 Valuation of Inventories.

Administration and other general overhead costs are not a component of the cost of tangible fixed asset because they cannot be directly attributed to the acquisition of the asset or bringing the asset to its working condition.

Non-Monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident. Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

Joint Ownership

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

Illustration 1

A publishing company undertook repair and overhauling of the machinery at a cost of ₹ 5 lakhs to maintain them in good condition and capitalized the amount, as it is more than 25% of the original cost of the machinery. Advice.

Solution:

The size of the expenditure is not the criteria to decide whether subsequent expenditure should be capitalized. The important question is whether the expenditure increases the future benefits from the asset beyond its pre-assessed standard of performance as per AS-10. Only then it should capitalize. Since, in this case, only the benefits are maintained at existing level, the expenditure should not be capitalized.

Illustration 2

A company purchased a machinery in the year 2009-10 for ₹ 90 lakhs. A balance of ₹ 10 lakhs is still payable to the suppliers for the same. The supplier waived off the balance amount during the financial year 2011-12. The company treated it as income and credited to profit and loss account during 2011-12. Whether accounting treatment is correct?

Solution:

As per para 9.1 of AS-10, the cost of fixed assets may undergo changes subsequent to its acquisition or construction on account of exchange fluctuation, price adjustments, changes in duties or similar factors. Considering para 9.1 the treatment done by the company is not correct. ₹ 10 lakhs should be deducted from the cost of the fixed assets.

Illustration 3

Z Ltd. purchased a machine costing ₹ 5 lakhs for its manufacturing operations and paid transportation costs ₹ 80,000. Z Ltd. spent an additional amount of ₹ 50,000 for testing and preparing the machine for use. What amount should Z Ltd. record as the cost of the machine?

Solution:

As per Para 20 of AS-10, the cost of the fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use. In this case, the cost of machinery includes all expenditures incurred in acquiring the asset and preparing it for use. Cost includes the purchase price, freight and handling charges, insurance cost on the machine while in transit, cost of special foundations, and costs of assembling, installation and testing. Therefore, the cost to be recorded is ₹ 6,30,000 (= 5,00,000 + 80,000 + 50,000).

AS 11: ACCOUNTING FOR THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

AS 11, (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements. As per this standard, a transaction in a foreign currency should be recorded in the reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency prevailing at the date of the transition. This exchange rate is known as spot rate. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for all transactions during the week or month in which the transactions occur. At each balance sheet date, the assets and liabilities should be converted into rupees at the closing exchange rate.

Exchange differences arising on foreign currency transactions should be recognised as income or as expense in the period in which they arise.

The financial statements of a foreign branch should be translated using the procedure as given below:

1) Revenue item, except opening and closing inventories and depreciation, should be translated into reporting currency of the reporting enterprise at average rate.
2) Monetary items (such as cash receivables and payables where money to the received or paid in fixed or determinable amounts of money) should be translated using the closing rate.
3) Non-monetary items other than inventories and fixed assets should be translated using the exchange rate at the date of the transaction.
4) Fixed assets should be translated using the exchange rate at the date of the transaction. Where there has been an increase or decrease in the liability of the enterprise by applying the closing rate, for making payment towards the whole or a part of the cost of the fixed assets, the amount by which the liability is so increased or decreased during the year.

5) Balance in the head office account should be reported at the amount of the balance in the branch account in the books of the head office after adjusting for un-responded transaction.
6) The net exchange difference resulting from the translating of the financial statements of a foreign branch into head office currency should be recognised as income or expense for the period.
7) Contingent liabilities should be translated into the reporting currency of the enterprise at the closing rate.

An enterprise should disclose the following in the financial statements:

(i) The amount of exchange difference included in the net profit or loss for the period.
(ii) The amount of exchange differences adjusted in the carrying amount of fixed assets during the accounting period; and
(iii) The amount of exchange differences in respect of forward exchange contracts to be recognised in the profit or loss for one or more subsequent accounting periods.

Illustration 1

A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.2011 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹42.50 as on 1.1.2011 and 31.12.2011 respectively. First instalment was paid on 31.12.2011. The entire difference in foreign exchange has been capitalized. You are required to state, how these transactions would be accounted for.

Solution:

As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise.

Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} \quad \frac{3{,}000 \text{ lakh}}{₹\ 40} = 75 \text{ lakhs US Dollars}$$

Exchange difference = 75 lakhs US Dollars × (42.50 – 40.00) = ₹ 187.50 lakhs (including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting ₹ 187.50 lakhs should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not exercised the option of capitalization available under para 46 of AS 11.

Illustration 2

	Exchange Rate
Goods purchased on 24.3.11 of US $1,00,000	₹ 46.60
Exchange rate on 31.3.2011	₹ 47.00
Date of actual payment 5.6.2012	₹ 47.50
Calculate the loss/gain for the financial years 2010-11 and 2011-12.	

Solution:

As per AS-11, all foreign currency transactions should be recorded by applying the exchange rate at the date of transaction. Therefore, goods purchased on 24.03.2011 and corresponding creditor would be recorded at ₹ 46.60 = 1,00,000 x 46.60 = 46,60,000

As per AS-11, at the balance sheet date all monetary items should be reported using the closing rate. Therefore, the creditors of US $1,00,000 outstanding on 31.3.2011 will be reported as:1,00,000 x 47.00 = 47,00,000.

Exchange loss ₹ 40,000 (= 47,00,000 – 46,60,000) should be debited in Profit and Loss Account for 2010-11.

As per AS-11, exchange difference on settlement on monetary items should be transferred to Profit and Loss Account as gain or loss thereof:

1,00,000 x 47.50 = 47,50,000 -47,00,000 = ₹ 50,000 should be debited to profit or loss for the year 2010-11.

AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

AS 12 deals with accounting for government grants like subsidies, cash incentives, duty drawbacks, etc. and specifies that the government grants should not be recognized until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. Government refers to Union/State, Govt. Agencies and similar bodies - Local, National or International. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, related to revenue, related to promoters' contribution; treatment for refund of government grants etc. The enterprises are required to disclose:

(i) the accounting policy adopted for government grants including the methods of presentation in the financial statements;

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

This Statement does not deal with:

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

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

(iii) Government participation in the ownership of the enterprise.

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period.

This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

In order to recognize the income there should be conclusive evidence that conditions attached to the grant have been or will be fulfilled to account for such earned benefits estimated on a prudent basis, even though the actual amount may be finally settled/received after the accounting period. Mere receipt would not suffice for income recognition. AS-4 (contingencies etc.) and AS-5 (Prior period etc.) would be applicable as the case may be.

The accounting for Govt. grants should be based on the nature of the relevant grant:

(a) In the nature of promoter's contribution as shareholders fund (capital approach)

(b) Otherwise as Income Approach to match with related cost recognizing AS-1 accrual concept disclosure.

Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

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

Illustration 1

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 50 crore in capital assets, received ₹ 10 crore from the Government in January, 2012 (accounting period being 2011-2012). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2012.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified?

Solution:

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

AS 13: ACCOUNTING FOR INVESTMENTS

AS-13 deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. AS 3 defines investments as follows:

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are non-investments.

Investments can be classified into two categories viz. Current Investment and Long Term investments. A current investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made. A long term investment is an investment other than a current investment"

According to AS-13, an enterprise should disclose current investment and long term investments distinctly in its financial statements. The cost of an investment should include acquisition charges such as brokerage, fees and duties. An enterprise holding investment properties should treat them as long term investment. Current investments should be carried in the financial statements at the lower of cost and fair value determined on an individual investment basis or by category of investment, but not on overall basis. Long term investment should be carried in the financial statements at cost. On sale of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

The following information should be disclosed in the financial investment:

a. According policies for determination of carrying amount of investment.
b. Classification of investments in current and long term as specified in the statute governing the enterprise.

In the absence of statutory requirements, investment may be classified as:

1) Government or trust securities
2) Shares, debentures or bonds
3) Investment properties, and
4) Others- specifying nature.

This Statement does not deal with:

a. The basis for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
b. Operating or finance leases.
c. Investments on retirement benefit plans and life insurance enterprises and
d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act.

Illustration 1

An unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2012 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000.

How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 2012?

Solution:

As it is stated in the question that financial statements for the year ended 31st March, 2012 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Para 17 of AS 13 ' Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to 20,000 in the financial statements for the year ended 31st March, 2012.

AS 15: EMPLOYEE BENEFITS

AS 15 generally deals with all forms of employee benefits given by an enterprise in exchange of services rendered by employee) other than stock compensation for which separate guideline is promulgated). AS 15 addresses only the accounting of employee benefits by employer. The standard makes four things very clear at the outset:

(a) The standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff):

(b) Employee benefits can be paid in cash or in kind:

(c) Employee benefits includes benefits provided to employees and their dependants (spouses, children, and others): and

(d) Payment can be made directly to employees, their dependents or any other party (e.g. insurance companies, trust etc.)

The statement applies to benefit usually comprising of:

(1) Short term employee benefits *(payable within 12 months after the year end) (Wages, salaries, paid leaves, profit sharing etc.)* and non–monetary benefits (*medical care, housing, car etc.)* for current employees;

(2) Post retirement benefits *(gratuity, pension, PF Post employment medical care etc.)*

(3) Long term employee benefits *(long term disability benefits)*

(4) Termination benefits *(e.g. VRS payment)*

This standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.

The standard lays down general recognition criteria for all short term employee benefit. The general criteria says that an enterprise should recognise short term benefits as an expense (unless otherwise provided by other standard) and any difference between the amount of expenses so recognized and cash payments made during the period should be treated as liability or prepayment (asset) as appropriate.

The accounting treatment and disclosure required for a post-retirement benefits plan depend upon whether it is:

(a) Defined Contribution Plans (DCP)

(b) Defined Benefit plan (DBP)

Under DCP, employer pays fixed contribution into separate fund and will have no obligation to pay further contribution. Contribution (e.g. PF) whether paid or payable for the reporting period is charged to P/L statement and excess if any is treated as prepayment. Any risk on account of actuarial and investment fall on the employee. However, in case of DBP contributions are charged to the income statement and any actuarial and investment risk lies with employer.

Accounting treatment for Gratuity benefit and other defined benefit Plan depends on the arrangement made by the employer:

(a) No separate fund i.e. out of nonspecific own fund:

- Provision for accruing liability in the P/L Account for the accounting period is made.
- The provision is based on an actuarial method or some other rational method (assumption that all employers are eligible at the end of the accounting period)

(b) Own separate/specific fund established through Trust:

The amount required to be contributed on actuarial basis is certified by the Actuary, and the actual contribution plus and shortfall to meet the actuarial amount is charged to P/L Account for the accounting period, any excess payment treated as prepayment.

(c) Fund established through Insurer: in the same manner as in (b) above

Actual valuation may be carried out annually (cost can be easily determined for the purpose of contribution as a charge to P/L) or periodically (say, once in 3 years) where Actuary's certificate specifies contribution on annual basis during inter-valuation period.

Leave encashment is an accrued estimated liability based on employers' past experience as to such benefit actually availed off and probability of encashment in future and therefore should relate to the period in which relevant service is rendered in compliance with Section 209(3) - accrual basis and AS-15.

Treatment of Termination Benefits:

Termination benefits are employee benefits payable as a result of either an enterprise's decision to terminate employees-employment before the normal retirement date or an employee decision to accept voluntary redundancy in exchange for those benefit (e.g. payment under Vrs)

1) Termination benefits to be paid irrespective of the voluntary retirement scheme i.e. balance in P.F, leave encashment; gratuity etc.

2) Termination benefits which are payable on account of VRS i.e. monetary payment on the basis of years of completed service or for the balance period of service whichever is less and notice pay. Expert Advisory Committee (EAC) opines in favour of treating the costs (except gratuity which should have been provided for in the respective accounting period) as deferred revenue expenditure since it is construed upon as saving in subsequent periods, on some rational basis over a period, preferably over 3 to 5 year. However, the terminal benefit is, to the extent these are not deferred should be treated as expense in the P/L Account with disclosure.

Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees who will accept an offer of Voluntary redundancy; a contingent liability exists and should be disclosed as per AS29 "Provisions, Contingent Liability and contingent assets"

This standard requires an enterprise to disclose:

a) In view of the varying practices, adequate disclosure of method of accounting for an understanding of the significance of such costs to an employer.

b) Disclosure separately made for statutory compliance or otherwise the retirement benefit costs are treated as an element of employee remuneration without specific disclosure.

c) Financial statements should disclose whether actuarial valuation is made at the end of the accounting period or earlier (in which case the date of actuarial valuation and the method used for accrual period if not based on actuary report).

Illustration 1

ZERO Bank has followed the policies for retirement benefits as under:

(a) Contribution to pension fund is made based on actuarial valuation at the year end. In respect of employees who have opted for pension scheme.

(b) Contribution to the gratuity fund is made based on actuarial valuation at the year end.

(c) Leave encashment is accounted for on "PAY-AS-YOU-GO" method.

Comment whether the policy is in accordance with AS-15.

Solution:

(a) As the contribution to Pension Fund is made on actuarial basis every year, therefore the policy is as per AS-15, which is based on actuarial basis of a counting.

(b) As the contribution is being made on annual basis to gratuity fund on actuarial basis, the policy is in accordance with AS-15.

(c) As regard leave encashment, which is accounted for on PAY-AS-YOU-GO basis, it is not in accordance with AS-15. It should be accounted for on accrual basis.

Illustration 2

In the context of relevant Accounting Standards, give your comment on the following matter for the financial year ending 31st March, 2012:

"Increase in pension liability on account of wage revision in 2011-12 is being provided for in 5 instalments commencing from that year. The remaining liability of ₹ 300 lakhs as re-determined in actuarial valuation will be provided for in the next 2 years"

Solution:

As per AS-15, the costs arising from an alteration in the retirement benefits to employees should be treated as follows:

(i) The cost may relate to the current year of service or to the past years of service.

(ii) In case of costs relating to the current year, the same may be charged to Profit and Loss Account

(iii) Where the cost relates to the past years of service these should be charged to Profit and Loss Account as 'prior period' items in accordance with AS-5.

(iv) Where retirement benefit scheme is amended in a manner which results in additional benefits being provided to retired employees, the cost of the additional benefits should be taken as " Prior Period and Extraordinary Items" as per AS-5.

In view of the above, the method adopted for accounting the increase in pension liability is not in consonance to the provisions mentioned in AS-15.

AS 29: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

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

This standard is not applicable to:

- Financial instruments carried at fair value
- Insurance enterprises
- Contract under which neither party has performed any of its obligations nor both parties have partially performed their obligation to an equal extent
- AS 7, AS 15, AS 19 and AS 22.

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

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A contingent liability is:

a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or a present obligation that arises from past events but is not recognized because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.

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

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

Possible obligation: an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A **restructuring** is a programme that is planned and controlled by management, and materially changes either (a) the scope of a business undertaken by an enterprise; or (b) the manner in which that business is conducted.

Past Event: A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Best Estimate: The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

Risks and Uncertainties: The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Future Events: Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Reimbursements: An, enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Such a reimbursement should be recognized only when it is virtually certain that it will be received consequent upon the settlement of the obligation

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason, in this situation, a provision is recognized for the full amount of the liability, and a separate asset for the expected reimbursement is recognized when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

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

Actuarial Gains and losses: Actuarial gains and losses comprise:

- Experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and
- The effects of changes in actuarial assumptions.

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. While this is the general principle, as per AS 15, in case an enterprise adopts the option to defer the recognition of any subsequent actuarial gains is limited to excess of cumulative (unrecognized gains) over the unrecognized portion of increase in transitional liability.

Disclosure:

For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period.

An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Illustration 1

There is an income tax demand of ₹ 2.5 lakhs against the company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The ground of appeal deals with the points covering ₹ 1.8 lakhs of the demand. State how the matter will have to be dealt with in the financial account for the year.

Solution:

A provision of ₹ 0.7 lakhs and a contingent liability of ₹ 1.8 lakhs should be provided in the financial accounts for the year.

Illustration 2

A company follows a policy of refunding money to the dissatisfied customers if they claim within 15 days from the date of purchase and return the goods. It appears from the past experience that in a month only 0.10% of the customers claim refunds. The company sold goods amounting to ₹ 20 lakhs during the last month of the financial year. Is there any contingency?

Solution:

There is a probable present obligation as a result of past obligating event. The obligating event is the sale of the product. Provision should be recognized as per AS-29. The best estimate for provision is ₹ 2,000 (₹ 20 lakhs x 0.1%).

Illustration 3

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the view point of finalization of accounts, taking note of the mandatory accounting standard.

Solution:

According to AS 15, actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

CHAPTER 7

Preparation of Balance Sheet and Profit & Loss Account of a company

Section 129 of the Companies Act, 2013 mandates that the financial statements should give a true and fair view of the state of affairs of the company, comply with the accounting standards notified under Act Section 133 and should be in the form provided in Schedule III to the Act.

The Schedule III contains general instructions for preparation of balance sheet and statement of profit and loss of a company. It also contains general instruction for preparation of consolidated Financial Statement

All the disclosures specified in the Accounting Standards, the Act and the Schedule should be made in the notes to accounts by the way of additional statement. Some of them are required to be disclosed on the face of the Financial Statements.

Notes to accounts should contain information in addition to that presented in the Financial Statements and where required should provide narrative descriptions or disaggregation's of items recognized in those statements and information about items that do not qualify for recognition in those statements.

Each item on the face of the Balance Sheet and Statement of Profit and Loss should be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

The unit of measurement should be used uniformly in the Financial Statements. Depending upon the turnover of the company, the figures appearing in the Financial Statements can be rounded off to nearest lakh, crores/ million (or decimal thereof) if turnover is ₹ 100 crore or more. If it is less, the figures can be rounded off to nearest hundreds, thousands, lakhs etc. The corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes should be given.

The Schedule sets out the following minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss and Notes. It specifies that line items, sub-line items and sub-totals should be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the Companies financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

Part-I: Balance Sheet

	Name of the Company…………………… Balance Sheet as at ……………………… (Rupees in…………)			
	Particulars	Note No.	Figures as at the end of current per last year	Figures as at the end of the previous per last year
	1	2	3	4
I	EQUITY & LIABILITIES			
	1. Shareholders' funds			
	(a) Share Capital			
	(b) Reserve & Capital			
	(c) Money received against share warrants			
	2. Share application money pending allotment			
	3. Non-Current liabilities			
	(a) Long term borrowings			
	(b) Deferred Tax Liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long Term provisions			
	4. Current liabilities			
	(a) Short term borrowings			
	(b) Trade payables			
	(c) Other current liabilities			
	(d) Short term provisions			
	TOTAL			

II	ASSETS			
	1. Non-current Assets			
	(a) Fixed Assets			
	(i) Tangible assets			
	(ii) Intangible assets			
	(iii) Capital work in progress			
	(iv) Intangible assets under development			
	(b) Non current investments			
	(c) Deferred tax assets (net)			
	(d) Long term loans and advances			
	(e) Other non-current assets			
	2. Current Assets			
	(a) Current Investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash & Cash equivalents			
	(e) Short term loans & advances			
	(f) Other current assets			
	TOTAL			

General instructions for preparation of balance sheet

1. An asset shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be realized in, or is intended for sale or consumption in, the Companies normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

   (c) it is expected to be realized within twelve months after the reporting date; or

   (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:
   (a) it is expected to be settled in the Companies normal operating cycle;
   (b) it is held primarily for the purpose of being traded;
   (c) it is due to be settled within twelve months after the reporting date; or
   (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   All other liabilities shall be classified as non-current.
4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A company shall disclose the following in the notes to accounts:

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) the number and amount of shares authorized;
(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
(c) Par value per share;
(d) Reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
(e) The rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
(f) Shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
(g) Shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;
(h) Shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

- (i) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
- (ii) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
- (iii) Aggregate number and class of shares bought back.

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

(k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(l) Forfeited shares (amount originally paid up)

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

- (a) Capital Reserves;
- (b) Capital Redemption Reserve;
- (c) Securities Premium Reserve;
- (d) Debenture Redemption Reserve;
- (e) Revaluation Reserve;
- (f) Share Options Outstanding Account;
- (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
- (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) A reserve specifically represented by earmarked investments shall be termed as a ‘fund’.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head ‘Surplus’. Similarly, the balance of ‘Reserves and Surplus’, after adjusting negative balance of surplus, if any, shall be shown under the head ‘Reserves and Surplus’ even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures.

(b) Term loans

(A) From banks.

(B) From other parties

(c) Deferred payment liabilities.

(d) Deposits.

(e) Loans and advances from related parties.

(f) Long term maturities of finance lease obligations

(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long Term Liabilities

Other Long term Liabilities shall be classified as:

(a) Trade payables

(b) Others

E. Long-Term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

F. Short-Term Borrowings

(i) Short-term borrowings shall be classified as:

- (a) Loans repayable on demand
  - (A) From banks
  - (B) From other parties
- (b) Loans and advances from related parties.
- (c) Deposits.
- (d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

G. Other Current Liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'

(h) Unpaid matured deposits and interest accrued thereon

(i) Unpaid matured debentures and interest accrued thereon

(j) Other payables (specify nature);

H. Short-Term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Tangible Assets

(i) Classification shall be given as:
- (a) Land.
- (b) Buildings.
- (c) Plant and Equipment.
- (d) Furniture and Fixtures.
- (e) Vehicles.
- (f) Office equipment.
- (g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible Assets

(i) Classification shall be given as:
- (a) Goodwill.
- (b) Brands /trademarks.
- (c) Computer software.

(d) Mastheads and publishing titles.
(e) Mining rights.
(f) Copyrights, and patents and other intellectual property rights, services and operating rights.
(g) Recipes formulae, models, designs and prototypes.
(h) Licenses and franchise.

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-Current Investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:
(a) Investment property;
(b) Investments in Equity Instruments;
(c) Investments in preference shares
(d) Investments in Government or trust securities;
(e) Investments in debentures or bonds;
(f) Investments in Mutual Funds;
(g) Investments in partnership firms
(h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

- (a) Aggregate amount of quoted investments and market value thereof;
- (b) Aggregate amount of unquoted investments;
- (c) Aggregate provision for diminution in value of investments.

L. Long-Term Loans and Advances

(i) Long-term loans and advances shall be classified as:

- (a) Capital Advances;
- (b) Security Deposits;
- (c) Loans and advances to related parties (giving details thereof);
- (d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other Non-Current Assets

Other non-current assets shall be classified as:

(i) Long Term Trade Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature)

(iii) Long term Trade Receivables, shall be sub-classified as:

- (a) (A) Secured, considered good; (B) Unsecured considered good; (C) Doubtful
- (b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as:

- (a) Investments in Equity Instruments;
- (b) Investment in Preference Shares
- (c) Investments in government or trust securities;
- (d) Investments in debentures or bonds;
- (e) Investments in Mutual Funds;
- (f) Investments in partnership firms
- (g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

- (a) The basis of valuation of individual investments
- (b) Aggregate amount of quoted investments and market value thereof;
- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

- (a) Raw materials;
- (b) Work-in-progress;
- (c) Finished goods;
- (d) Stock-in-trade (in respect of goods acquired for trading);
- (e) Stores and spares;
- (f) Loose tools;
- (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:
- (a) Secured, considered good;
- (b) Unsecured considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and Cash Equivalents

(i) Cash and cash equivalents shall be classified as:
- (a) Balances with banks;
- (b) Cheques, drafts on hand;
- (c) Cash on hand;
- (d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

R. Short-Term Loans and Advances

(i) Short-term loans and advances shall be classified as:
- (a) Loans and advances to related parties (giving details thereof);
- (b) Others (specify nature).

(ii) The above shall also be sub-classified as:
- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other Current Assets (Specify Nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent Liabilities and Commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

  (a) Claims against the company not acknowledged as debt;

  (b) Guarantees;

  (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

  (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

  (b) Uncalled liability on shares and other investments partly paid

  (c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company……………………….
Profit and loss statement for the year ended ………………………

(Rupees in………..)

	Particulars	Note No.	Figures at the end of current reporting period	Figures at the end of current reporting period
I	Revenue from operations		xxx	xxx
II	Other Income		xxx	xxx
III	Total Revenue (I+I)			
IV	Expenses:			
	Cost of material consumed			xxx
	Purchase of Stock in trade			xxx
	Change in inventories of finished goods, work in progress & Stock in Trade			xxx
	Employee Benefit Expenses		xxx	xxx
	Finance Cost		xxx	xxx
	Depreciation & amortisation expenses		xxx	xxx
	Other Expenses		xxx	xxx
	Total Expenses		xxx	xxx
			xxx	xxx
V	Profit before exceptional and extra ordinary items and tax (III-IV)		xxx	xxx
VI	Exceptional items		xxx	xxx
VII	Profit before extra-ordinary items & tax (V-VI)		xxx	xxx
VIII	Extraordinary items		xxx	xxx
IX	Profit before Tax (VII-VIII)		xxx	xxx
X	Tax Expenses			
	(a) Current Tax		xxx	xxx
	(b) (2) Deferred Tax		xxx	xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	xxx
XII	Profit (Loss) from discontinuing operations		xxx	xxx
XIII	Tax expenses of discontinuing operations		xxx	xxx

XIV	Profit (Loss) from discontinuing operations (after tax) (XII-XIII)			
XV	Profit (Loss) for the period (XI-XIV)		xxx	xxx
XVI	Earnings per equity share:			
	(1) Basic		xxx	xxx
	(2) Diluted		xxx	xxx

General instructions for preparation of Statement of Profit and Loss

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (ii) of Clause (40) of Section 2 in like manner as they apply to a statement of profit and loss.

2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from

   (a) Sale of products;

   (b) Sale of services;

   (c) Other operating revenues; Less:

   (d) Excise duty.

   (B) In respect of a finance company, revenue from operations shall include revenue from

   (a) Interest; and

   (b) Other financial services

   Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

   Finance costs shall be classified as:

   (a) Interest expense;

   (b) Other borrowing costs;

   (c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

   Other income shall be classified as:

   (a) Interest Income (in case of a company other than a finance company);

   (b) Dividend Income;

   (c) Net gain/loss on sale of investments

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

5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

I. (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortization expense;

(c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs. 1,00,000, whichever is higher;

(d) Interest Income;

(e) Interest Expense;

(f) Dividend Income;

(g) Net gain/ loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(j) Payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses;

(k) In case of companies covered u/s 135, amount of expenditure incurred on corporate social responsibility activities;

(l) Details of items of exceptional and extraordinary nature;

(m) Prior period items;

II. (a) In the case of manufacturing companies,

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

III. In the case of all concerns having works in progress, works-in-progress under broad heads.

IV. (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

V. (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

VI. Expenditure incurred on each of the following items, separately for each item:-

(a) Consumption of stores and spare parts:

(b) Power & Fuel

(c) Rent

(d) Repair to Building:

(e) Repair to Machinery

(f) Insurance

(g) Rates & Taxes, excluding Taxes on Income

(h) Miscellaneous Expenses

VII. (a) Dividends from \subsidiary companies;

(b) Provisions for losses of subsidiary companies

VIII. The profit and loss account shall also contain by way of a note the following information, namely:-

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

I. Raw materials;

II. Components and spare parts;

III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:-

- Export of goods calculated in FOB basis,
- Royalty, Know How, professional and consultation fees;
- Interest and Dividend
- Other Income, indicating the nature thereof

CHAPTER 8

CONSOLIDATED FINANCIAL STATEMENTS

(Ind-AS 27 and IAS 27)

Introduction

Accounting for business combinations has undergone a thorough overhaul in recent years, first in the US, later by the IASB, and by national standard setters in other jurisdictions as well. IFRS 3, introduced in 2004, like FAS 141, the US GAAP standard, ends the use of pooling of interests accounting, and treats goodwill arising from an acquisition as an intangible asset with an indefinite life, not subject to periodic amortization. The standard also requires that, where there is a minority interest, the assets and liabilities in a subsidiary are now to be valued at full fair value, including the minority interest's portion.

IASB is currently pursuing a project (recently renamed Control [Including Special Purpose Entities]) to address both the basis (policy) on which a parent entity should consolidate its investments in subsidiaries, and the actual procedures for consolidation. It is intended that this will provide more rigorous guidance on the concept of control, which is the basis for consolidation under IAS 27. Among other matters to be resolved is that of special-purpose entities (SPE), which are utilized for "off the books" financings, leasing activities, and other purposes. Under US GAAP, these have mostly been redefined as "variable interest entities" and stricter, if much more complex, criteria have established, with the objective of forcing adherence to the "substance over form" practice of consolidating SPEs when they are, effectively, economically integrated with the reporting entity.

When a combination is accounted for as an acquisition, as now is virtually always the case, the assets acquired and liabilities assumed are recorded at their respective fair values, using purchase accounting. If the fair value of the net assets acquired equal an amount other than the total acquisition price, the excess (or less commonly, the deficiency) is generally referred to as goodwill (a deficiency is commonly, if confusingly, called negative goodwill).

Goodwill of this kind can arise only in the context of a business combination. While fair values of many assets liabilities can readily be determined (and in an arm's-length transaction should among these are the value of contingent consideration promised to former owners of the acquired entity, and the determination as to whether certain expenses that arise by virtue of the transaction, such as those pertaining to elimination of duplicate facilities, should be treated as part of the transaction or as an element of post acquisition accounting.

At an operational level, acquired entities are either maintained as operating subsidiaries or their assets and liabilities are absorbed into the acquirer's existing business. The financial reporting of the surviving entity or the consolidated financial reporting of the parent company will be identical in either case, but in the latter the subsidiary's own (separate company) financial statements preserve its historical cost carrying values, so there will be a need to maintain "memo" records so that asset and liability step-ups or step-downs (to reflect fair values as of the acquisition date, further adjusted for amortization and other occurrences thereafter until the financial statement date) can be made in preparing consolidated financial statements. Where the assets and liabilities are transferred to the acquirer, the records for the acquiring unit will reflect the new carrying values of assets and liabilities as at the date of acquisition.

Major accounting issues affecting business combinations and the preparation of consolidated or combined financial statements pertain to the following:

The proper recognition and measurement of the assets and liabilities of the combining entities,

The elimination of intercompany balances and transactions in the preparation of consolidated financial statements,

The manner of reporting the minority interest.

Corporate financial reporting and disclosures play a crucial role in bringing transparency in the functioning of an enterprise thereby improving its functional efficiency besides being one of the important constituents of corporate governance structure. One of the major instruments in improved financial reporting is the preparation of Consolidated Financial Statements (CFS). Consolidated Financial Statements are the financial statements of a group, presented by a parent/holding company, in which the assets, liabilities, equity, income, expenses and cash flows of the holding company and its subsidiary companies are presented as those of a single economic entity. The purpose of CFS is to highlight the financial position and operational performance of the group which would not have been apparent from the standalone financial statements.

Regulatory Framework (prior to Companies Act, 2013)

Financial reporting in India has been governed by the Companies Act, 1956, the Indian Accounting Standards formulated and issued by the Institute of Chartered Accountants of India and by the listing agreements. The preparation and presentation of the CFS in India has been regulated as under:

Section 212 of the Companies Act, 1956 requires holding Companies to attach the financial statements of each of its subsidiaries along with the holding Company's interest therein with its own standalone financial statements.

Clause 41 of the listing agreement also requires submission of annual audited consolidated financial results for listed companies while submitting annual audited financial results prepared on stand-alone basis to the stock exchange within sixty days from the end of the financial year.

Preparation of CFS is required to comply with the requirements of Accounting Standard-21 (Consolidated Financial Statements), Accounting Standard-23 (Accounting for Investments in Associates in Consolidated Financial Statements) and Accounting Standard-27 (Financial Reporting of Interests in Joint Ventures) issued and specified by the Institute of Chartered Accountants of India (ICAI) under Section 211 of the Companies Act, 1956.

Regulatory Framework (post Companies Act, 2013)

The Companies Act, 2013 focuses on corporate reporting framework and some of the significant changes relating to CFS are as under:

Mandatory Preparation of Consolidated Financial Statements

Section 129(3), of the Companies Act 2013 mandates preparation of CFS for all parent/ holding company companies having one or more subsidiaries in addition to the separate financial statements and the same are required to be prepared in the same form and manner as the separate financial statements. For the purpose of this Section, the word subsidiary would include *associate companies* and *joint ventures*. The requirements of Schedule-III of the Companies Act, 2013, which lays down the format for preparation of financial statements, apply *mutatis mutandis* on the preparation of CFS by a company. Under Section 129(4), the requirements concerning preparation, adoption and audit of financial statements of a holding company shall, *mutatis mutandis,* apply to CFS. Other requirements for CFS, if any, are stated in the Act at appropriate places.

Definitions of Subsidiary, Associate and Joint Venture

The definitions of the terms 'subsidiary' and 'associates' have been modified under the Companies Act , 2013 and the term 'joint venture is defined under AS-23 only. The definitions are discussed below:

Subsidiary

The Companies Act, 1956 did not define the term "control." It explains the meaning of terms "holding company", and "subsidiary" as *a company will be deemed to be a subsidiary of another company if, but only if the other company controls the composition of its board of directors, or controls more than one-half of the voting power of an enterprise*.

Companies Act, 2013 defines 'subsidiary' as a company of which the 'holding' company controls more than one-half of the total share capital (either directly or indirectly) or controls composition of the board of directors. Control includes right to appoint majority of the directors.

The definition of a subsidiary under the Companies Act 2013 is based on ownership of the total share capital which includes convertible preference share capital [only **convertible** preference share capital, as per Rules 2(r)(b) of Companies (Specification of definitions details) Rules, 2014].

In contrast, AS 21 on CFS defines a subsidiary as an enterprise that is controlled by another enterprise. Control is defined as the ownership, directly or indirectly through subsidiary (ies), of more than one-half of the voting power of an enterprise; and / or (b) control of the composition of the board of directors.

The definition of a subsidiary under the 2013 is based on ownership of the total share capital which includes convertible preference share capital. This will have a significant impact on several companies which have issued preference shares. Also this definition does not consider the concept of control over voting power covered in Companies Act 1956 and AS-21.

While the definition of the term 'subsidiary' is confined to a company registered under the Companies Act 2013, the same extend to non-company under para 10 of AS-21.

Associate

The Companies Act, 1956 did not define the term "associate" or "associate company." Notified Accounting Standard-23 (Accounting for Investments in Associates in Consolidated Financial Statements) defines the term **"associate" as "an enterprise** in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor." Accounting Standard-23 defines the term "significant influence" as "the power to participate in the financial/operating policy decisions of the investee but not control over those policies."

Companies Act, 2013 defines an 'associate' as a company in which that other company has a 'significant influence', but which is not a subsidiary company of the company having such influence and includes a joint venture company. 'Significant influence' means control of at least 20% of total share capital, or of business decisions under an agreement.

The subsidiary and associate company as defined in the Companies Act, 2013 are as under-

HOLDING COMPANY	Subsidiary Company	Owns/ Controls more than 50% of the share capital or exercises control over the Board of Directors
	Associate Company	Owns/ Controls 20% or more of the share capital, or business decisions under an agreement

Joint Ventures:

The term ‘joint venture’ has not been defined under the Companies Act, but it has been defined under AS-27. Under AS-27 (i) a joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control, (ii) Joint control is the contractually agreed sharing of control over an economic activity, (iii) Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it, (iv) a venturer is a party to a joint venture and has joint control over that joint venture.

Additional disclosure requirements

Section 129 of the Companies Act, 2013 requires the company to attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed. Such statement has been prescribed under Rule-5 of the Company (Accounts) Rule, 2014. However, Rule-6 states that a company covered u/s 129(3), which is not required to prepare consolidate financial statement under the Accounting Standards, it shall be sufficient that the company complies with provisions on CFS provided in schedule-III of the Act.

Schedule-III of the Companies Act, 2013 containing the general instructions for the preparation of CFS requires the companies to disclose by way of a statement, the share in profit/loss and net assets of each subsidiary, associate and joint ventures as additional information. It also requires the companies to cover all subsidiaries, associates and joint ventures (whether Indian or foreign) under CFS and disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the CFS along with the reasons of not consolidating.

Preparation of Consolidated Financial Statements and its format

Consolidated Financial Statements are presented for a group of entities under the control of a parent. A ‘parent’ is an entity that has one or more subsidiaries. A group comprises a parent and its subsidiaries. Thus, CFS are the financial statements of a group presented by parent/holding Company.

As per Section 129 of the Companies Act 1956, CFS are required to be presented, to the extent possible, in the same format as adopted by the parent for its separate standalone financial statements i.e. Schedule-III, and additional information are to be disclosed as required under Accounting Standards and Rules prescribed under Section 129(3) of the Act.

MCA has amended this position through the Company (Accounts) Amendment Rules, 2014 notified in October 2014. The rule 6 of Companies (Accounts) Rules, 2014 has been amended to provide two sets of exemptions from preparing CFS:

Companies which do not have any subsidiary company but has one or more associate companies or JVs or both, are exempted from preparing CFS for the financial year 2014-15.

Intermediate wholly owned subsidiary companies, whose immediate parent is a company incorporated in India, do not need to prepare CFS.

The preparation of CFS broadly involve:

- Identifying components (subsidiaries/ associates/ joint ventures);
- Obtaining accurate and complete financial information from components;
- Including the financial information of the components in the CFS;
- Identifying reportable segments for segmental reporting;
- Identifying related parties and related party transactions for reporting,
- Making appropriate consolidation adjustments.

For this purpose, the parent company generally issues instructions to the Management of components for supplying the required financial information of the components for inclusion in the CFS within a pre-defined reporting time table. The information required relates to the accounting policies to be applied, statutory and other disclosure requirements, identification of and reporting on reportable segments, related parties and related party transactions.

Consolidation Procedures and Principles: AS-21

The Accounting Standard-21 (Consolidated Financial Statements) issued by ICAI lays down the following procedures/principles to be applied in the preparation of CFS:

The financial statements of the parent and its subsidiaries should be combined on a *line by line basi*s by adding together like items of assets, liabilities, income and expenses.

The cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated. Any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as *goodwill* to be recognized as an asset in the CFS. When the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a *capital reserve* in the CFS.

Minority interests in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.

Intra-group balances and intra-group transactions and resulting un-realised profits should be eliminated in full. Un-realised losses resulting from intra-group transactions should also be eliminated unless cost cannot be recovered.

The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.

Consolidated Financial Statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing CFS, that fact should be disclosed together with the proportions of the items in the CFS to which the different accounting policies have been applied.

An investment in an enterprise should be accounted for in accordance with Accounting Standard-13 (Accounting for Investments), from the date that the enterprise ceases to be a subsidiary and does not become an associate.

The consolidation process would include the following steps generally:

Collection of information from the subsidiaries, associates, JVs

Line by line consolidation of the financial statements of the Company and its subsidiaries and JVs.

Elimination of inter unit transactions/ balances

Valuation of goodwill/ capital reserve arising from the difference between the cost of investment in a subsidiary/ associate and its net assets (equity) at the time of acquisition.

Valuation of minority interest

Valuation of investment in associates

Consolidation of accounting policies and notes

Requirements of Consolidated Financial Statements.

IAS27, as most recently revised, prescribes the requirements for the presentation of consolidated financial statements. A parent entity must present consolidated financial statements in order to comply with IFRS, unless all of the following conditions apply:

1. It is a wholly owned subsidiary, or if the owners of the minority interests including those not otherwise entitled to vote, unanimously agree that the parent need not present consolidated financial statements;
2. its securities are not publicly traded;

3. It is not in the process of issuing securities in public securities markets; and
4. The immediate or ultimate parent publishes consolidated financial statements that comply with IFRS.

Under the provisions of revised IAS 27, when the conditions above are all satisfied and as a consequence the parent chooses not to present consolidated financial statements but to instead present separate financial statements, then all investments in subsidiaries, jointly controlled entities and associates that the consolidated, proportionally consolidated or accounted for under the equity method in consolidated financial statements prepared in accordance with the requirements of IAS 31 or IAS 28, must be accounted for either at cost, or as available-for-sale financial assets in accordance with IAS 39. The same method must be applied for each category of investments. In other words, if consolidated financial reporting is foregone, then equity method accounting or proportional consolidation is also precluded.

Revised IAS 27 stipulates that under the cost method, an investor recognizes its investment in the investee at cost. Income is recognized only to the extent that the investor receives distributions from the accumulated net profits of the investee arising after the date of acquisition by the investor. Distributions received in excess of such profits are to be regarde4d as recoveries of the investment, and are to e accounted for as a reduction of the cost of the investment (i.e.., as a return of capital).

Furthermore, investments, in subsidiaries, jointly controlled entities and associates that ate accounted for in accordance with IAS 39 in the consolidated financial statements are to be accounted for in the same way in the investor's separate financial statements and in the financial statements of a parent that need not present consolidated financial statements.

IAS holds that users of the financial statements of a parent entity, joint venture, or investor in an associate are usually concerned with an need to be informed about the financial position, results of operations, and changes in financial position of the groups as a whole, this need is served by consolidated financial statements or financial statements in which the associate is accounted for under the equity method that present financial Information about the group as a single economic entity without regard for the legal boundaries of the separate legal entities.

The "substance over form" imperative, which is not always heeded in financial reporting, is normally given great weight in these reporting matters. On the other hand, separate financial statements present financial information about the entity's position viewed as an investor. The implication is that, even when permissible under IFRS, separate financial reporting is not viewed as being more useful than consolidated reporting. For this reason, the following disclosures have to be made in the investor's separate financial statements and in the financial statements of a parent that need not present consolidated financial statements:

- The reasons why separate financial statements are being presented;

- The name of the immediate or ultimate parent and a reference to the consolidated financial statements and/or the financial statements in which associates and jointly controlled entities are accounted for under the equity method or proportionate consolidation method in accordance with IAS 28 and IAS 31, respectively; and
- A description of the method used to account for investments in subsidiaries, associates and jointly controlled entities.

In addition to the foregoing elective option to not present consolidated financial statements, IAS 27 essentially continues its predecessor's prohibition of consolidation when there is an absence of control over a subsidiary. Consolidated financial statements are to consolidate a parent and all of its subsidiaries, foreign and domestic, when those entities are controlled by the parent. For making this determination, control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than one-half of the voting power of an entity-unless, in exceptional circumstances, it can be clearly demonstrated that this ownership does not connote control. Control also exists when the parent owns one-half or less of the voting power of an entity when there is:

- Power over more than one-half of the voting rights by virtue of an agreement with other investors (e.g., a voting trust);
- Power to govern the financial and operating policies of the entity under a statute or an agreement;
- Power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- Power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

Control may furthermore be precluded when an investee is in legal reorganization or in bankruptcy or operates under severe long-term restrictions on its ability to transfer funds to the investor. Thus, under unusual circumstances, a majority owned subsidiary would be excluded from consolidation.

Additionally (under the terms of IFRS 5), a subsidiary must be excluded from consolidation when control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to subsequent disposal within twelve months from acquisition. Investments in such subsidiaries should be treated as a disposal group, and accounted for at fair value less costs to sell, with any later changes in fair value included in profit or loss of the period of the change. Categorization as a disposal group is dependent upon the subsidiary being available for sale in its present condition, as well as there being both a management commitment to sell and a high probability of disposal actually taking place within twelve months from the date of acquisition.

The exceptions to consolidation are strictly limited and cannot be generalized from the situations described above. Thus, a subsidiary cannot be excluded from consolidation simply because the investor is a venture capital organization, mutual fund, unit trust, or similar entity. Also, a subsidiary cannot be excluded from consolidation because its business activities are dissimilar from those of the other entities within the group. It is presumed that more relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. The disclosure model of IAS 14 for segment information may be relevant to such an exercise in the case of no homogeneous consolidated subsidiaries.

Impact of Potential Voting Interests on Consolidation

Historically, actual voting interests in subsidiaries has been the criterion used to determine (a) if consolidated financial statements are to be presented; and (b) what percentage to apply in determining the allocation of a subsidiary's income, included in consolidated earnings, between the parent and the minority interests.

However, as revised, IAS 27 also addresses the situation where the parent entity has, in addition to its actual voting shareholder interest, a further potential voting interest in the subsidiary. (This was first addressed by SIC 33, which was withdrawn when IAS 27 was revised).

A potential interest may due to the existence of options, warrants, convertible shares, or a contractual agreement to acquire additional shares, including shares that the investor or parent entity may have sold to another shareholder in the subsidiary or to another party, with a right or contractual arrangement to reacquire the shares transferred at a later date.

As to whether the potential shares should be considered in reaching a decision as to whether control is present, and thus whether the reporting entity is to be regarded as the parent company and should therefore prepare consolidated financial statements, IAS 27 holds that this is indeed a factor to weigh. It concluded that the existence and effect of potential voting rights that are presently exercisable or presently convertible should be considered, in addition to the other factors set forth in IAS 27, when assessing whether an enterprise controls another enterprise. All potential voting rights should be considered, including ay potential voting rights held by other enterprises, which would mitigate or even eliminate the impact of the reporting entity's potential voting interest.

For example, an entity holding 40% voting rights in another entity, but having options to acquire another 15% voting interest, the effect of which is not offset by options held by another party, would effectively have a 55% current and potential voting interest, making consolidation required under IAS 27.

On the other hand, concerning whether the potential share interest should be taken into account when determining what fraction of the subsidiary's income should be allocated to the parent, the general answer is no. IAS 27 states that the proportion allocated to the parent and to minority interests, respectively, when preparing consolidated financial statements should be determined solely on present ownership interests. That is, potential ownership may necessitate consolidated financial reporting, but income or loss allocation is still to be based on actual, not potential, ownership percentages.

However, the enterprise may, in substance, have a present ownership interest when it sells and simultaneously agrees to repurchase some of the voting shares it had held in the subsidiary. In such a situation, it does not lose control of access to economic benefits associated with an ownership interest. In this circumstance, the proportion allocated should be determined by taking into account the eventual exercise of potential voting rights and other derivatives that, in substance, give present access to the economic benefits associated with an ownership interest. Note that the right to reacquire shares alone is not enough to have those shares included for purposes of determining the percentage of the subsidiary's income to be reported by the parent. Rather, the parent must have ongoing access to the economic benefits of ownership of those shares.

Inter-Company Transactions and Balances

In preparing consolidated financial statements, any transactions among members of the group must be eliminated. For example, a parent may sell merchandise to its subsidiary, at cost or with a profit margin added, before the subsidiary ultimately sells the merchandise to unrelated parties in arm's-length transactions. Furthermore, any balances, due to or from members of the consolidated group at the end of the reporting period must also be eliminated. The reason for this requirement: to avoid grossing up the financial statements for transactions or balances those do not represent economic events with outside parties. Were this rule not in effect, a consolidated group could create the appearance of being a much larger enterprise than it is in reality merely by engaging in multiple transactions with itself.

Different Fiscal Periods of Parent and Subsidiary

A practical consideration in preparing consolidated financial statement is to have information on all constituent entities current as of the parent's year-end. If the subsidiaries have different fiscal years, they may prepare updated information as of the parent's year-end, to be used for preparing consolidated statements. Failing this, IAS 27 permits combining information as of different dates, as long as this discrepancy does not exceed three months. Of course, if this option is elected, the process of eliminating intercompany transactions and balances may become a bit more complicated, since reciprocal accounts (e.g., sales and cost of sales) will be out of balance for any events occurring after the earlier fiscal year-end but before the later one.

Uniformity of Accounting Policies

There is a presumption that all the members of the consolidated group should use the same accounting principles to account for similar events and transactions. However, in many cases this will not occur, as, for example, when a subsidiary is acquired that users FIFO costing for its inventories while the parent has long employed the LIFO method. (Note that LIFO is not longer permitted under provisions of revise IAS 2. The average cost method is still permitted as an alternative to FIFO.) IAS 27 does not demand that one of the other entities change its method of accounting; rather, it merely requires that there be adequate disclosure of the accounting principles employed.

If a subsidiary was acquired during the period, the results of the operations of the subsidiary should be included in consolidate financial statements only for the period it was owned. Since this may cause comparability with earlier periods presented to be impaired, there must be adequate disclosure in the accompanying footnotes to make it possible to interpret the information properly. The post tax profits or losses of operations that have been sold or classified as held for sale during the period should be disclosed separately on the face of the income statement as discontinued operations.

Consolidated Statements in Subsequent Periods with Minority Interests

When a company acquires some, but not all, of the voting stock of another entity, the shares held by third parties represent a minority interest in the acquired company, under IFRS, if a parae3nt company controls another entity in some other way (as discussed above), the two should be consolidated or financial statement purposes (unless to do so would mislead the statement users because control is temporary or the businesses are heterogeneous, etc.). The minority interest in equity and profit of the consolidated entity must also be accounted for.

When consolidated statements are prepared, the full amount of assets and liabilities (in the statement of financial position) and income and expenses (in the income statement) of the subsidiary are generally presented. Accordingly, a contra must be shown for the portion of these items that does not belong to the parent company. In the statement of financial position this contra is normally is normally is credit item shown within shareholders' representing the minority interest in consolidated equity (net assets) equal to the minority's percentage ownership in the equity of the subsidiary entity. Although less likely, a debit balance in minority interest could result when the subsidiary has a deficit in its shareholders' equity and when there is reason to believe that the minority owners will make additional capital contributions to erase that deficit. This situation sometimes occurs where the entities are closely held and the minority owners are related parties having other business relationships with the parent company and/or its stockholders. In other circumstances, a debit minority interest would be charged against parent company retained earnings under the concept that the loss will be borne by that company.

IAS 27 as revised stipulates that minority interest be presented in the consolidated statement of financial position as separate component of, but within, shareholders' equity. Previously, IAS 27 permitted minority interest to be shown in a separate caption positioned between liabilities and equity. However, IASB determined that it did not meet the definition of a liability and should be included with equity.

In the consolidated income statement, (if prepared separately, to present items of comprehensive income in two statements), the minority interest in the income (or loss) of a consolidated subsidiary is shown as a deduction form (or addition to) the consolidated profit or loss account. As above, if the minority interest in equity of the subsidiary has already been reduced to zero, and if a net debit minority interest will not be recorded (the usual case), the minority's interest in any further losses should not be recorded. (however, this must be explained in the footnotes,) furthermore, if past minority losses have not been recorded, the minority's interest in current profits will not be recognized until the aggregate of such profits equals the aggregate unrecognized losses. This closely parallels the furl for equity method accounting recognition of profits and losses.

IAS 27 states that income attributable to minority interest be separately presented in the statement of comprehensive income. Generally, this is accomplished by presenting profit and total comprehensive income, attributable separately to owners of the parent and minority interest.

Consolidated Financial Statement shall include:

1. Consolidated Balance Sheet including Consolidated Statement changes in Equity, presented as a part of Consolidated Balance Sheet)
2. Consolidated Statement of Profit & Loss

While preparing the Consolidated Balance Sheet following points must be taken into account:

1. An asset shall be classified as current when it satisfies any of the following criteria:
   (a) it is expected to be realized in, or is intended for sale or consumption in, the entity's normal operating cycle;
   (b) it is held primarily for the purpose of being traded;
   (c) it is expected to be realized within twelve months after the reporting date; or
   (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.
2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:
   (a) it is expected to be settled in the entity's normal operating cycle;
   (b) it is held primarily for the purpose of being traded;
   (c) it is due to be settled within twelve months after the reporting date; or
   (d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   All other liabilities shall be classified as non-current.
4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. The following shall be disclosed in the notes to accounts:

A. Equity Share Capital:

For each class of equity share capital pertaining to the owners of the parent and the non-controlling interests, wherever applicable:

(a) the number and amount of shares authorised;
(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
(c) par value per share;
(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
(f) shares held by each shareholder holding more than 5 percent shares specifying the number of shares held;
(g) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
(h) For the period of five years immediately preceding the date as at which the Consolidated Balance Sheet is prepared:

Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.

Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

Aggregate number and class of shares bought back.

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

(j) Calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(k) Forfeited shares (amount originally paid up)

B. Other Equity

(i) Reserves under Óther Equity' shall be sub-classified as-

1.1 Reserves representing unrealized gains/losses (Details to be given in the Consolidated Statement of Changes in Equity);

1.2 Other Reserves

(ii) 'Other Reserves' shall be classified in the notes as:

(a) Capital Reserves;

(b) Capital Redemption Reserve;

(c) Securities Premium Reserve;

(d) Debenture Redemption Reserve;

(e) Share Options Outstanding Account

(f) Others – (specify the nature and purpose of each reserve and the amount in respect thereof);

(Additions and deductions since last consolidated balance sheet to be shown under each of the specified heads)

(iii) Retained Earnings represents surplus i.e. balance of the relevant column in the Consolidated statement of Changes in Equity.

(iv) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(v) Debit balance of the Consolidated Statement of Profit and Loss shall be shown as a negative figure under the head 'retained earnings'. Similarly, the balance of 'Other Equity', after adjusting negative lance of retained earnings, if any, shall be shown under the head 'Other Equity' even if the resulting figure is in the negative.

(vi) Under the sub-head 'Other Equity', disclosure shall be made for the nature and amount of each item.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures

(b) Term loans

(c) Deferred payment liabilities.

(d) Deposits.

(e) Loans and advances from related parties.

(f) Long term maturities of finance lease obligations

(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest, and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the entity has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the consolidated balance sheet date in repayment of loans/bonds/debentures and interest shall be specified separately in each case.

D. Other Long Term Liabilities:

Other long term liabilities shall be classified as:

(a) Trade payables

(b) Others

E. Long-Term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

F. Short-Term Borrowings

(i) Short-term borrowings shall be classified as:
  - (a) Loans repayable on demand
  - (b) Loans and advances from related parties.
  - (c) Deposits.
  - (d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the consolidated balance sheet date in repayment of loans and interest, shall be specified separately in each case.

G. Other Current Liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;
(b) Current maturities of finance lease obligations;
(c) Interest accrued but not due on borrowings;
(d) Interest accrued and due on borrowings;
(e) Income received in advance;
(f) Unpaid dividends
(g) Application money received for allotment of securities and due for refund and interest accrued thereon
(h) Unpaid matured deposits and interest accrued thereon
(i) Unpaid matured debentures and interest accrued thereon
(j) Other payables (specify nature);

H. Short-Term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits.
(b) Others (specify nature).

I. Property, Plant and Equipment (PPE)

(i) Classification shall be given as:
  - (a) Land.
  - (b) Buildings.
  - (c) Plant and Equipment.

(d) Furniture and Fixtures.
(e) Vehicles.
(f) Office equipment.
(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Goodwill

A reconciliation of the gross and net carrying amount of goodwill at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments.

K. Other Intangible Assets

(i) Classification shall be given as:

(a) Brands /trademarks.
(b) Computer software.
(c) Mastheads and publishing titles.
(d) Mining rights.
(e) Copyrights, and patents and other intellectual property rights, services and operating rights.
(f) Recipes, formulae, models, designs and prototypes.
(g) Licenses and franchise.
(h) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

L. Non-Current Investments

(i) Non-current investments shall be classified as:

(a) Investments in Equity Instruments;(b) Investments in Preference Shares;
(c) Investments in Government or trust securities;
(d) Investments in debentures or bonds;
(e) Investments in Mutual Funds;
(f) Investments in partnership firms;
(g) Other non-current investments (specify nature)

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments

M. Long-Term Loans and Advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;

(b) Security Deposits;

(c) Loans and advances to related parties (giving details thereof);

(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the Group or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Other Non-Current Assets

Other non-current assets shall be classified as-

(i) Long Term Trade and Other Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature);

(iii) Long term Trade and Other Receivables shall be sub-classified as:

(1) (a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful;

(2) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately

(3) Debts due by directors or other officers of the Group or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

O. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;
(b) Investment in Preference Shares;
(c) Investments in government or trust securities;
(d) Investments in debentures or bonds;
(e) Investments in Mutual Funds;
(f) Investments in partnership firms
(g) Other investments (specify nature).

(ii) The following shall also be disclosed

(a) The basis of valuation of individual investments
(b) Aggregate amount of quoted investments and market value thereof;
(c) Aggregate amount of unquoted investments;
(d) Aggregate provision for diminution in value of investments.

P. Inventories

(i) Inventories shall be classified as:
(a) Raw materials;
(b) Work-in-progress;
(c) Finished goods;
(d) Stock-in-trade (in respect of goods acquired for trading);
(e) Stores and spares;
(f) Loose tools;
(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

Q. Trade and Other Receivables

(i) Aggregate amount of Trade and Other Receivables outstanding for a period exceeding six months from he date they are due for payment should be separately stated.

(ii) Trade and Other Receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the Group or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a artner or a director or a member should be separately stated.

R. Cash and Cash Equivalents

(i) Cash and cash equivalents shall be classified as:
- (a) Balances with Banks;
- (b) Cheques, drafts on hand;
- (c) Cash on hand;
- (d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

S. Short-Term Loans and Advances

(i) Short-term loans and advances shall be classified as:
- (a) Loans and advances to related parties (giving details thereof);
- (b) Others (specify nature).

(ii) The above shall also be sub-classified as:
- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the Group or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

T. Other Current Assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

U. Contingent Liabilities and Commitments (to the extent not provided for)

(i) Contingent Liabilities shall be classified as:

(a) Claims against the Group not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the Group is contingently liable

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid;

(c) Other commitments (specify nature).

V. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on irredeemable preference shares shall also be disclosed separately.

W. If any of the current assets do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact shall be stated.

7. When an accounting policy is applied retrospectively or items in the consolidated financial statements re restated or when items are reclassified in consolidated financial statements, a Consolidated Balance Sheet as at the beginning of the earliest comparative period from which the above adjustments are made hall be attached to the Consolidated Balance Sheet.

8. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the prospectus or the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Óther current liabilities'.

9. Preference shares shall be classified and presented as 'Equity' or 'Liability' in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in this regard applicable to the relevant class of equity or liability shall be applicable mutatis mutandis to the preference shares. For instance, redeemable preference shares shall be classified and presented under 'liabilities' as 'long term borrowings' and the disclosure requirements in this regard applicable to such borrowings shall be applicable mutatis mutandis to redeemable preference shares.

10. Compound financial instruments such as convertible debentures, where split into equity and liability components, as per the requirements of the relevant Indian Accounting Standards, shall be classified and presented under the relevant heads in 'Equity and 'Liabilities'

Form of Consolidated Financial Statements

PART I – CONSOLIDATED BALANCE SHEET

Name of the Group…………………….

Consolidated Balance Sheet as at ………………………

(₹ in…………)

Sr. No.	Particulars	Note No.	Figures for the current reporting period		Figures for the previous reporting period
I.	Revenue From Operations		xxx		xxx
	Other Income		xxx		xxx
	Total revenue (I)		xxx		xxx
II.	**Expenses** Cost of material consumed		xxx		xxx
	Purchases of Stock-in-Trade		xxx		xxx
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress		xxx		xxx
	Employee benefits expense		xxx		xxx
	Finance costs		xxx		xxx
	Depreciation and amortization expense		xxx		xxx
	Other expenses		xxx		xxx
	Total expenses (II)		xxx		xxx

III.	Profit before exceptional items and tax (I-II)		xxx		xxx
IV.	Exceptional Items		xxx		xxx
V.	Profit/(loss) before tax (III-IV)		xxx		xxx
VI.	Tax expense: (1) Current tax (2) Deferred tax	 xxx xxx		 xxx xxx	
VII.	Profit (Loss) for the period from continuing operations (V-VI)		xxx		xxx
VIII.	Profit/(loss) from discontinued operations		xxx		xxx
IX.	Tax expense of discontinued operations		xxx		xxx
X.	Profit/(loss) from Discontinued operations (after tax) (VIII-IX)		xxx		xxx
XI.	Profit/(loss) for the period attributable to (VII+ X) (a)Owners of the parent (b)Non-controlling Interests	 xxx xxx	 xxx	 xxx xxx	 xxx
XII.	Other Comprehensive Income attributable to (a)Owners of the parent (b)Non-controlling Interests	 xxx xxx	 xxx	 xxx xxx	 xxx
XIII.	Total Comprehensive Income for the period (XI + XII)(Comprising Profit (Loss) and Other Comprehensive Income for the period) attributable to (a)Owners of the parent (b)Non-controlling Interests	 xxx xxx	 xxx	 xxx xxx	 xxx
XIV.	Total comprehensive income as adjusted by the prior period errors and changes in accounting policies which have been applied retrospectively as per the requirements of the relevant Indian Accounting Standards		xxx		
XV.	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted		 xxx xxx		 xxx xxx

XVI.	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted		 xxx xxx		 xxx xxx
XVII.	Earnings per equity share(for discontinued & continuing operations) (1) Basic (2) Diluted		 xxx xxx		 Xxx xxx

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(presented as a part of Consolidated Balance Sheet)

Name of the Group……………………

Consolidated Statement of Changes in Equity for the period ended ……………………

(₹ in……………..)

(a) Equity Share Capital

	Balance at the beginning of the reporting period Balance	**Changes in equity share capital during the year**	**Balance at the end of the reporting period**
Attributable to owners of the parent	xxx	xxx	xxx
Attributable to non-controlling interests	xxx	xxx	xxx
Total	xxx	xxx	xxx

(b) Other Equity

	Balance at the beginning of the reporting period	Changes in accounting policy/ prior period errors	Restated balance at the beginning of the reporting period	Dividends	Total Comprehensive Income for the year	Transfer to retained earnings	Any other change (to be specified)	Balance at the end of the reporting period
i) Equity component of other financial instruments	xxx	-----	xxx	-----	----	----	xxx	xxx
ii) Retained Earnings	xxx	xxx	xxx	(xxx)	xxx	xxx	xxx	xxx
iii) Reserves								
1.1 Reserves representing unrealised gains/losses								

Available for sale financial assets	xxx	-----	xxx	-----	xxx	----	xxx	xxx
Effective portion of cash Flow Hedges	xxx	-----	xxx	-----	xxx	----	xxx	xxx
Re-valuation Surplus	xxx	-----	xxx	-----	xxx	(xxx)	xxx	xxx
Actuarial gains a and losses defined benefit plans	xxx	-----	xxx	-----	xxx	----	xxx	xxx
Exchange difference on translating the financial statements of a foreign operation	xxx	-----	xxx	-----	xxx	----	xxx	xxx
Others	xxx	----	xxx	-----	xxx	xxx	xxx	xxx
1.2 other reserves								
Total Reserves (iii)	xxx	----	xxx	-----	xxx	xxx		
iv) Money received against share warrants	xxx	-----	xxx	-----	----	----	xxx	xxx
v) Others	xxx	xxx	xxx	(xxx)	xxx	xxx	xxx	xxx
Other equity attributable to parent	xxx	xxx	xxx	(xxx)	xxx	xxx	xxx	xxx
Other equity attributable to non-controlling interests	xxx	xxx	xxx	(xxx)	xxx	xxx	xxx	xxx
Total other equity	xxx	xxx	xxx	(xxx)	xxx	xxx	xxx	xxx

Consolidated Statement of Profit and Loss: The Consolidated Statement of Profit and Loss shall include (1) Profit or loss for the period; (2) Other Comprehensive Income for the period.

(A) In respect of business other than financing business, revenue from operations shall disclose separately in the notes revenue from

(a) sale of products;

(b) sale of services;

(c) other operating revenues;

Less:

(d) Excise duty.

(B) In respect of financing business, revenue from operations shall include revenue from

(a) Interest; and

(b) Other financial services

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

While preparing the consolidated statement of Profit & Loss Account Finance costs shall be classified as (a) Interest; (b) Dividend on redeemable preference shares (c) Applicable net gain/loss on foreign currency transactions and translation.(d) Other borrowing costs (specify nature);5 Other income. Similarly Other income shall be classified as (a) Interest Income (in case of a company other than a finance company);(b) Dividend Income (c) Other non-operating income (net of expenses directly attributable to such income). Other Comprehensive Income shall be classified into (i) Changes in revaluation surplus (ii) Gains and losses on re-measuring available–for–sale financial assets (iii) The effective portion of gains and loss on hedging instruments in a cash flow Hedge (iv) Actuarial gains and losses on defined benefit plans (v) Exchange differences in translating the financial statements of a foreign operation (vi) Others (specifying nature)

Further, any additional Information regarding aggregate expenditure and income on the following items shall be Disclosed by way of notes, additional information:

(i) (a) Employee Benefits expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortization expense;

(c) Any item of expenditure which exceeds one per cent of the revenue from operations or Rs.10,00,000, whichever is higher;

(d) Interest Income;

(e) Interest Expense;

(f) Dividend income

(g) Net gain/loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain/loss on foreign currency translation and translation (other than considered as finance cost);

(j) Payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses;

(k) Details of items of exceptional nature;

(ii) (a) In the case of manufacturing operations of the Group,-

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading operations of the Group, purchases in respect of goods traded in by the Group under broad heads.

(c) In the case of operation of rendering or supplying services, gross income derived form services rendered or supplied under broad heads.

(d) In the case of a Group, which carries on more than one of the operations mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of others, gross income derived under broad heads.

(iii) In the case of all concerns having work in progress, work-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the consolidated balance-sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(vi) Expenditure incurred on each of the following items, separately for each item:-

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(g) Insurance .

(h) Rates and taxes, excluding, taxes on income.

(i) Miscellaneous expenses:

PART II – CONSOLIDATED STATEMENT OF PROFIT AND LOSS

Name of the Group……………………..

Consolidated Statement of Profit and Loss for the period ended ………………………

(₹ in…………)

	Particulars	Note No.	Figures for the current reporting period		Figures for the previous reporting period
I.	Revenue From Operations		xxx		xxx
	Other Income		xxx		xxx
	Total revenue (I)		XXX		XXX
II.	**Expenses** Cost of material consumed		XXX		XXX
	Purchases of Stock-in-Trade		xxx		xxx
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress		xxx		xxx
	Employee benefits expense		xxx		xxx
	Finance costs		xxx		xxx
	Depreciation and amortization expense		xxx		xxx
	Other expenses		xxx		xxx
	Total expenses (II)		xxx		xxx
III.	Profit before exceptional items and tax (I-II)		xxx		xxx
IV.	Exceptional Items		xxx		xxx
V.	Profit/(loss) before tax (III-IV)		xxx		xxx
VI.	Tax expense: (1) Current tax (2) Deferred tax	 xxx xxx	 xxx	 xxx xxx	 xxx
VII.	Profit (Loss) for the period from continuing operations (V-VI)		xxx		xxx
VIII.	Profit/(loss) from discontinued operations		xxx		xxx
IX.	Tax expense of discontinued operations		xxx		xxx
X.	Profit/(loss) from Discontinued operations (after tax) (VIII-IX)		xxx		xxx

XI.	Profit/(loss) for the period attributable to (VII+ X) (a)Owners of the parent (b)Non-controlling Interests	 xxx xxx	 XXX	 xxx xxx	 XXX
XII.	Other Comprehensive Income attributable to (a)Owners of the parent (b)Non-controlling Interests	 xxx xxx	 XXX	 xxx xxx	 XXX
XIII.	Total Comprehensive Income for the period (XI + XII)(Comprising Profit (Loss) and Other Comprehensive Income for the period) attributable to (a)Owners of the parent (b)Non-controlling Interests	xxx xxx	XXX	xxx xxx	XXX
XIV.	Total comprehensive income as adjusted by the prior period errors and changes in accounting policies which have been applied retrospectively as per the requirements of the relevant Indian Accounting Standards		XXX		
XV.	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted		 xxx xxx		 xxx xxx
XVI.	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted		 xxx xxx		 xxx xxx
XVII.	Earnings per equity share(for discontinued & continuing operations) (1) Basic (2) Diluted		 xxx xxx		 xxx xxx

Besides the consolidated Balance Sheet and statement of Profit & Loss Account, the following shall also be disclosed by way of additional information. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statements. List of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating shall also be disclosed.

Name of the entity in the Group	**Net Assets, i.e., total assets minus total liabilities**		**Share in profit or loss**		**Share in other comprehensive income**		**Share in total comprehensive income**	
	As % of consolidated net assets	Amount	As % of consolidated other comprehensive income	Amount	As % of total comprehensive income	Amount	As % of total comprehensive income	Amount
Parent								
Subsidiaries Indian 1. 2. Foreign 1. 2.								
Non controlling interests in all subsidiaries Associates (Investments as per the equity method) Indian 1. 2 Foreign 1. 2.								
Joint ventures (as per proportionate consolidation/ investment as per the equity method Indian 1. 2. Foreign 1. 2.								
Total								

CHAPTER 9

Cash Flow Statement & Funds Flow Statement

A simple definition of a cash flow statement is a statement which discloses the changes in cash position between the two periods. For example, a balance sheet shows the balance of cash as on 31.3.2013 at ₹ 30,000/- while the cash balance as per its latest balance sheet as on 31.3.2014 was ₹ 40,000/-. Thus, there has been an inflow of ₹ 10,000/- during a year's period.

Along with changes in the cash position the cash flow statement also outlines the reasons for such inflows or outflows of cash which in turn helps to analyse the functioning of a business. The term cash comprises cash on hand, demand deposits with the banks and includes cash equivalents.

Utility of Cash Flow Analysis:

The cash flow statement is an important planning tool in the hands of management. A cash flow statement is useful for short-term planning.

A business enterprise needs sufficient cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debts maturing in the near future, expenses of the business, etc. A historical analysis of the different sources and applications of cash will enable the management to make reliable cash flow projections for the immediate future. It may then plan out for investment of surplus or meeting the deficit, if any.

Its chief advantages and utility are as follows:

1. Helps in Efficient Cash Management: It helps to determine how much cash will be available at a particular point of time to meet obligations like payment to trade creditors, repayment of cash loans, dividends, etc. This helps to provide information about the liquidity and solvency information of an enterprise.

2. Helps in Internal Financial Management: A proper planning of the cash resources will enable the management to make available sufficient cash whenever needed and invest surplus cash, if any in productive and profitable opportunities.
3. Discloses the Movements of Cash: It helps in understanding and analysis of what are the sources and application of the cash for a company. Also it discloses the volume as well as the speed at which the cash flows in the different segments of the business, thereby helping to analyse the different segments of the business.
4. Historical versus Future Estimates: Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows.
5. Discloses the Success or Failure of Cash Planning: It helps in determining how efficiently the cash is being managed by the management of the business.
6. Comparison between Two Enterprises: Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.
7. Analysis of Profitability vis-à-vis Net Cash Flow: It is also useful in examining the relationship between profitability and net cash flow.

Limitations of Cash Flow Analysis:

Cash flow analysis is a useful tool of financial analysis. However, it has its own limitations. These limitations are as under:

1. Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non-cash items and, therefore, net cash flow does not necessarily mean net income of the business.
2. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.
3. Cash flow statement cannot replace the Funds Flow Statement. Each of them has a separate function to perform.

In spite of these limitations it can be said that cash flow statement is a useful supplementary instrument.

The technique of cash flow analysis, when used in conjunction with ratio analysis, serves as a barometer in measuring the profitability and financial position of the business.

Revised Cash Flow Statement (AS: 3)

The cash flow statement is prepared in accordance with the provisions contained in AS 3 (Revised) issued by the Council of the Institute of Chartered Accountants of India. It is advised to read the standard thoroughly to learn various intricacies relating to preparation of cash flow statement.

The AS 3 (Revised) while laying down its objectives says that information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to 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.

The Statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

Definitions:

AS 3 (Revised) has defined the following terms as follows:

(a) Cash comprises cash on hand and demand deposits with banks.

(b) Cash equivalents are short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

(c) Cash flows are inflows and outflows of cash and cash equivalents.

(d) Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

(e) Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

(f) Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Cash and Cash Equivalents:

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of say, three months or less from the date of acquisition.

Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

Presentation of Cash Flow Statement

The cash flow statement should report cash flows during the period classified into following categories:

a. Operating activities

b. Investing activities

c. Financing activities

Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include mix of cash flows that are classified differently. For example, the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

(a) Cash receipts from the sale of goods and the rendering of services;

(b) Cash receipts from royalties, fees, commissions and other revenue;

(c) Cash payments to suppliers for goods and services;

(d) Cash payments to and on behalf of employees;

(e) Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

(f) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) Cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

Some Additional Points: Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities.

Similarly loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities

The activities of acquisition and disposal of long-term assets and other investments not included in cash equivalents are investing activities. Separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of cash flows arising from investing activities are:

(a) Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalized research and development costs and self-constructed fixed assets;

(b) Cash receipts from disposal of fixed assets (including intangibles);

(c) Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(f) Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(g) Cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) Cash receipts from futures contracts, forward contracts, option contacts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

Financing activities are those activities which result in change in size and composition of owner's capital and borrowing of the organization. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

Examples of cash flows arising from financing activities are:

(a) Cash proceeds from issuing shares or other similar instruments;

(b) Cash proceeds from issuing debentures, loans, notes, bonds and other short or long-term borrowings; and

(c) Cash repayments of amounts borrowed.

In addition to the general classification of three types of cash flows, the applicable Accounting Standards provides for the treatment of the cash flows of certain special items (Special Items Treatment) as under:

Foreign Currency Cash Flows: Cash flows arising from transactions in a foreign currency should be recorded in an enterprises reporting currency.

The reporting should be done by applying the exchange rate at the date of cash flow statement.

A rate which approximates the actual rate may also be used. For example, weighted average exchange rate for a period may be used for recording foreign currency transactions.

The effect of changes in exchange rates on cash and cash equivalents held in foreign currency should be reported as a separate part in the form of reconciliation in order to reconcile cash and cash equivalents at the beginning and end of the period.

Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. The difference of amount raised due to changes in exchange rate should not be included in operating investing and financing activities. This shall be shown separately in the reconciliation statement.

Extraordinary Items: Any cash flows relating to extraordinary items should as far as possible classify them into operating, investing or financing activities and those items should be separately disclosed in the cash flow statement. Some of the examples for extraordinary items is bad debts recovered, claims from insurance companies, winning of a law suit or lottery etc.

The above disclosure is in addition to disclosure mentioned in AS-5, 'Net Profit or Loss for the period, prior period items and changes in accounting policies.'

Interest and Dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. The treatment of interest and dividends, received and paid, depends upon the nature of the enterprise i.e., financial enterprises and other enterprises. In case of financial enterprises, cash flows arising from interest paid and interest & Dividends received, should be classified as cash flows from operating activities. In case of other enterprises, Cash outflows arising from interest paid on terms loans and debentures should be classified as cash outflows from financing activities. Cash outflows arising from interest paid on working capital loans should be classified as cash outflow from operating activities. Interest and dividends received should be classified as cash inflow from investing activities. Interest and dividends received should be classified as cash inflow from investing activities. Dividend paid on equity and preference share capital should be classified as cash outflow from financing activities.

Taxes on Income: Cash flows arising from taxes on income should be separately disclosed. It should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investments in Subsidiaries, Associates and Joint Ventures: Any such investments should be reported in the cash flow statement as investing activity. Any dividends received should also be reported as cash flow from investing activity.

Non-Cash Transactions: Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these do not involve cash flows in the current period. Examples of non-cash transactions:

(a) The acquisition of assets by assuming directly related liabilities.

(b) The acquisition of an enterprise by means of issue of shares.

(c) Conversion of debt into equity.

Procedure in Preparation of Cash Flow Statement

The procedure used for the preparation of cash flow statement is as follows:

Calculation of net increase or decrease in cash and cash equivalents accounts: The difference between cash and cash equivalents for the period may be computed by comparing these accounts given in the comparative balance sheets. The results will be cash receipts and payments during the period responsible for the increase or decrease in cash and cash equivalent items.

Calculation of the net cash provided or used by operating activities: It is by the analysis of Profit and Loss Account, Comparative Balance Sheet and selected additional information.

Calculation of the net cash provided or used by investing and financing activities: All other changes in the Balance sheet items must be analysed taking into account the additional information and effect on cash may be grouped under the investing and financing activities.

Final Preparation of a Cash Flow Statement: It may be prepared by classifying all cash inflows and outflows in terms of operating, investing and financing activities. The net cash flow provided or used in each of these three activities may be highlighted. Ensure that the aggregate of net cash flows from operating, investing and financing activities is equal to net increase or decrease in cash and cash equivalents.

Report any significant investing financing transactions that did not involve cash or cash equivalents in a separate schedule to the Cash Flow Statement.

Reporting of Cash Flow from Operating Activities

The financial statements are generally prepared on accrual basis of accounting under which the net income will not indicate the net cash provided by or net loss will not indicate the net cash used in operating activities.

In order to calculate the net cash flows in operating activities, it is necessary to replace revenues and expenses with actual receipts and payments in cash. This is done by eliminating the non-cash revenues and/non-cash expenses from the given earned revenues

There are two methods of converting net profit into net cash flows from operating activities-

(i) Direct method, and

(ii) Indirect method.

(i) Direct Method

Under direct method, actual cash receipts (for a period) from operating revenues and actual cash payments (for a period) for operating expenses are arranged and presented in the cash flow statement. The difference between cash receipts and cash payments is the net cash flow from operating activities.

It is in effect a cash basis Profit and Loss account.

Under direct method, items like depreciation, amortisation of intangible assets, preliminary expenses, debenture discount, etc. are ignored from cash flow statement since the direct method includes only cash transactions and non-cash items are omitted.

Likewise, no adjustment is made for loss or gain on the sale of fixed assets and investments.

(ii) Indirect Method

In this method, the net profit (loss) is used as the base then adjusted for items that affected net profit but did not affect cash.

Non-cash and non-operating charges in the Profit and Loss account are added back to the net profit while non-cash and non-operating credits are deducted to calculate operating profit before working capital changes. It is a partial conversion of accrual basis profit to cash basis profit. Further necessary adjustments are made for increase or decrease in current assets and current liabilities to obtain net cash from operating activities.

Other Disclosure Requirements

1. If any significant cash and cash equivalent balances held by the enterprise are not available for use by it, it should be disclosed in the cash flow statement.

   For example cash held by the overseas branch which is not available for use by the enterprise due to exchange control regulations or due to other legal restrictions.

2. Any additional information to understand the financial position and liquidity position of an enterprise should be disclosed.

   For example: The amount of undrawn borrowing facilities that may be available for future operating activities and to settlement of capital commitments, indicating any restrictions on the use of these facilities; and

3. The aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

4. A reconciliation of cash and cash equivalents given in its cash flow statement with equivalent items reported in the Balance Sheet.

5. An enterprise should disclose the policy which it adopts in determining the composition of cash and cash equivalent. The effect of any change in the policy for determining components of cash and cash equivalents should be reported in accordance with AS-5, 'Net Profit or Loss for the period, Prior period items, and Changes in accounting policies'.

Format of Cash Flow Statement: As 3 (Revised) has not provided any specific format for the preparation of cash flow statements, but a general idea can be had from the illustration given in the appendix to the Accounting Standard. There seems to be flexibility in the presentation of cash flow statements. However, a widely accepted format under direct method and indirect method is given below:

Option 1:- Cash Flow Statement (Direct Method)			₹
Cash Flow from Operating Activities			
Cash receipts from customers		xxx	

Cash paid to suppliers and employees		(xxx)	
Cash generated from operations		xxx	
Income tax paid		(xxx)	
Cash flow before extraordinary items		xxx	
Proceeds from earthquake disaster settlement etc.		xxx	
Net cash from Operating Activities	(a)		xxx
Cash Flows from investing Activities			
Purchase of fixed assets		(xxx)	
Proceeds from sale of equipment		xxx	
Interest received		xxx	
Dividend received		xxx	
Net cash from investing Activities	(b)		xxx
Cash flows from Financing Activities			
Proceeds from issuance of share capital		xxx	
Proceeds from long-term borrowings		xxx	
Repayments of long term borrowings		(xxx)	
Interest paid		(xxx)	
Dividend paid		(xxx)	
Net cash from Financing Activities	(c)		xxx
Net increase (decrease) in Cash and Cash Equivalent	(a+b+c)		xxx
Cash and Cash Equivalents at beginning of period			xxx
Cash and cash Equivalent at end of period			xxx
Option 2: Cash Flow Statement (Indirect Method)			
Cash Flow from Operating Activities			
Net Profit before tax and extraordinary items		xxx	
Adjustments for:			
-Depreciation		xxx	
-Foreign exchange		xxx	
-Investments		xxx	
-Gain or loss on sale of fixed assets		(xxx)	
-Interest/dividend		xxx	
Operating profit before working capital changes		xxx	
Adjustments for:			
-Trade and other receivables		xxx	
-Inventories		(xxx)	

-Trade payable		xxx	
Cash generation from operations		xxx	
-Interest paid		(xxx)	
-Direct Taxes		(xxx)	
Cash before extraordinary items		xxx	
Deferred revenue		xxx	
Net cash from Operating Activities	(a)		xxx
Cash Flow from Investing Activities			
Purchase of fixed assets		(xxx)	
Sale of fixed assets		xxx	
Purchase of investments		xxx	
Interest received		(xxx)	
Dividend received		xxx	
Loans to subsidiaries		xxx	
Net cash from Investing Activities	(b)		xxx
Cash Flow from Financing Activities			
Proceeds from issue of share capital		xxx	
Proceeds from long term borrowings		xxx	
Repayment to finance/lease liabilities		(xxx)	
Dividend paid		(xxx)	
Net cash from Financing Activities	(c)		xxx
Net increase (decrease) in Cash and Cash Equivalents	(a+b+c)		xxx
Cash and Cash Equivalents at the beginning of the year			xxx
Cash and Cash Equivalents at the end of the year			xxx

Cash from Operations (₹)

Funds from Operations				xxx
Add:	Increase in Current Liabilities	(excluding Bank Overdraft)	xxx	
	Decrease in Current Assets	(excluding cash & bank balance)	xxx	
Less:	Increase in Current Assets	(excluding cash & bank balance)	xxx	
	Decrease in Current Liabilities	(excluding bank overdraft)	xxx	xxx
Cash from Operations				xxx

The concept and technique of preparing a Cash Flow Statement will be clear with the help of illustrations given below:

Illustration 1. From the following information prepare a Cash Flow Statement according to (a) Direct Method (b) indirect Method as per AS 3 (Revised). Working notes would form part of your answer

BALANCE SHEET
As on 31.12.2013

(₹ In '000)

	2013	2012
Assets		
Cash on hand and balances with banks	200	25
Short-term investments	670	25
Sundry debtors	1,700	135
Interest receivable	100	1,200
Inventories	900	--
Long-term investments	2,500	2,500
Fixed assets at cost	2,180	1,910
Less: Accumulated depreciation	(1,450)	(1,060)
Fixed assets (net)	730	850
Total Assets	6,800	6,660
Liabilities		
Sundry creditors	150	1,890
Interest payable	230	100
Income taxes payable	400	1,000
Long-term debt	1,110	1,040
Total liabilities	1,890	4,030
Shareholders' funds		
Share capital	1,500	1,250
Reserves	3,410	1,380
Total shareholders' funds	4,910	2,630
Total Liabilities and Shareholders' funds	6,800	6,660

STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31.12.2013 (₹ in '000)	
Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administrative and selling expenses	(910)
Interest expense	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item-	
Insurance proceeds from earthquake disaster settlement	180
Net profit after extraordinary item	3,530
Income tax	(300)
Net Profit	3,230

Additional Information: (Figures in ₹ '000).

(a An amount of 250 was raised from the issue of share capital and a further 250 was raised from long-term borrowings.

(b) Interest expense was 400 of which 170 was paid during the period. 100 relating to interest expense of the prior period was also paid during the period.

(c) Dividends paid were 1,200.

(d) Tax deducted at source on dividends received (included in the tax expense of 300for the year) amounted to 40.

(e) During the period, the enterprise acquired fixed assets for 350. The payment was made in cash.

(f) Plant with original cost of 80 and accumulated depreciation of 60 was sold for 20.

(g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short – term investment in foreign currency designated bounds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

Solution

CASH FLOW STATEMENT (Direct Method)		
		(₹ In '000)
		2013
Cash flows from operating activities		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870
Cash flows from investing activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividend received	160	
Net cash from investing activities		30
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayments of long-term borrowings	(180)	
Interest paid	(270)	
Dividend paid	(1,200)	
Net cash used in financing activities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period (See Note 1)		160
Cash and cash equivalents at end of period (See Note 1)		910

Notes to the Cash Flow Statement (Direct & Indirect Method)

1. Cash and Equivalents: Cash and cash equivalents consist of cash on hand and balance with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts.

	2013	2012
Cash on hand and balances with banks	200	25
Short-term investments	670	135
Cash and cash equivalents	970	160
Effects of exchange rate transactions	40	-
Cash and cash equivalent as restated	910	160

Cash and cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely permissible to the company because of currency exchange restrictions.

The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

CASH FLOW STATEMENT (Indirect Method)		**(₹ in '000)**
Cash Flows from Operating Activities		
Net profit before taxation, and extraordinary item	3,350	
Adjustment for:		
Depreciation	450	
Foreign exchange loss	40	
Interest income	(300)	
Dividend income	(200)	
Interest expense	400	
Operating profit before working capital changes	3,740	
Increase in sundry debtors	(5,00)	
Decrease in inventories	1,050	
Decrease in sundry creditors	(1,740)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flows before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870

Cash Flows from Investing Activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	160	
Net cash from investing activities		30
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period (See Note 1)		160
Cash and cash equivalents at end of period (See Note 1)		910

Alternative Presentation (Indirect Method)

As an alternative, in an indirect method cash flow statement, operating profit before working capital changes is sometime presented as follows:

Revenues excluding investment income	30,650
Operating expenses excluding depreciation	-26,910
Operating profit before working capital changes	3,740

Working Notes:

The working notes given below do not form part of the cash flow statement. The purpose of these working notes is merely to assist in understanding the manner in which various figures in the cash flow statement have been derived. (Figures are in ₹ in 000).

1	Cash receipts from customers		
	Sales		30,650
	Add: sundry debtors at the end of the year		1,200
			31,850
	Less: Sundry debtors at the end of the year		1,700
			30,150

2	Cash paid to suppliers and employees		
	Cost of sales		26,000
	Administrative & selling expenses		910
			26,910
	Add: Sundry creditors to the beginning of the year	1,890	
	Inventories at the end of the year	900	2,790
			29,700
	Less: sundry creditors at the end of the year	150	
	Inventories at the beginning of the year	1,950	2,100
			27,600
3	Income taxes paid (including tax deducted at source form dividends received)		
	Income tax expenses for the year (including tax deducted at sources from dividends received		300
	Add: income tax liability at the beginning of the year		1,000
			1,300
	Less: income tax liability at the end of the year		400
			900
	Out of 900, tax deducted at source on dividends received (amounting to 40), is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities.		
4	Repayment of long-term borrowings		1,040
	Long-term debt at the beginning of the year		250
	Add: long-term borrowings made of the year		1,290
	Less: long-term borrowings at the end of the year		1,110
			180
5	Interest paid		
	Interest expense for the year		400
	Add: interest payable at the beginning of the year		100
			500
	Less: Interest payable at the end of the year		230
			270

Illustration 2 Swastik Oils Ltd. has furnished the following information for the year ended 31st March, 2014: (₹ In Lakhs)	
Net profit	37,500.00
Dividend (including interim dividend paid)	12,000.00
Provision for income-tax	7,500.00
Income-tax paid during the year	6,372.00
Loss on sale of assets (net)	60
Book value of assets sold	277.50
Depreciation charged to P&L Account	30,000.00
Profit on sale of investments	150.00
Interest income on investments	3,759.00
Value of investments sold	41,647.50
Interest expenses (due during the year)	15,000.00
Interest paid during the year	15,780.00
Increase in working capital (excluding cash and bank balance)	84,112.50
Purchase of fixed assets	21,840.00
Investments in joint venture	5,775.00
Expenditure on construction work-in-progress	69,480.00
Proceeds from long-term borrowings	38,970.00
Proceeds from short-term borrowings	30,862.50
Opening cash and bank balances	11,032.50
Closing cash and bank balances	2,569.50

You are required to prepare the cash flow statement in accordance with AS 3 for the year ended 31st March, 2014. (Make assumptions wherever necessary).

Solution:

SWASTIK OILS LIMITED Cash Flow Statement for the year ended 31st March, 2014		
a)	Cash Flows from operating Activities	(₹ In lakhs)
	Net profit before taxation (37,500+7,500)	45,000.00
	Adjustment for:	
	Depreciation charged to P&L A/c	30,000.00
	Loss on sale of investments	60
	Profit on sale of investments	-150

	Interest income on investments	-3,759.00
	Interest expenses	15,000.00
	Operating profit before working capital changes	86,151.00
	Increase (change) in working capital (excluding cash and bank balance)	-84,112.50
	Cash generated from operations	
	Income tax paid	2,038.50
	Net cash used operating activities (A)	-6,372.00
		-4,333.50
b)	Cash Flow from investing Activities	
	Sale of assets (277.50-60.60)	217.5
	Sale of investments (41,647.50+150)	41,797.50
	Interest income on investments (Assumed)	3,759.00
	Purchase of fixed assets	-21,840.00
	Investments in Joint Venture	-5,775.00
	Expenditure on construction work-in-progress	-69,480.00
	Net Cash used in investing activities (B)	-51,321.00
c)	Cash Flow from Financing Activities	
	Proceeds from long-term borrowings	38,970.00
	Proceeds from short-term borrowings	30,862.50
	Interest paid	-15,780.00
	Dividends (including interim dividend paid)	-12,000.00
	Bet cash from financing activities (c)	42,052.50
	Bet increase in cash and cash equivalents (A) +(B) +(c)	-13,602.00
	Cash and cash equivalents at the beginning of the year	11,032.50
	Cash and cash equivalents at the end of the year	2,569.50

B. FUNDS FLOW STATEMENT

Another important tool in the hands of finance managers for ascertaining the changes in financial position of a firm between two accounting periods is known as funds flow statement. Funds flow statement analyses the reasons for change in financial position between two balance sheets. It shows the inflow and outflow of funds i.e., sources and application of funds during a particular period.

Fund Flow Statement summarizes for a particular period the resources made available to finance the activities of an enterprise and the uses to which such resources have been put. A fund flow statement may serve as supplementary financial information to the users.

Meaning of Fund

'Fund' means working capital. Working capital is viewed as the difference between current assets and current liabilities. If we see balance sheets of a company for two consecutive years, we can note that working capital in such Balance Sheets are different.

Change in Working Capital

Even when a firm is earning adequate profit it may be short of fund for day to day working. Such a situation may be the result of:

(a) Purchase of fixed assets or long-term investments during the phase of extension without raising long-term funds by issue of shares or debentures;

(b) Payment of dividends in excess of profits earned;

(c) Extension of credit to the customers;

(d) Holding larger stock to the current levels; and

(e) Repaying a long-term liability or redemption of preference shares without raising long-term resources.

Elements of Funds Flow Statement

We have already seen that there are numerous movements in funds in an accounting year. It is important to understand these movements since they affect the financial position of a company. This is done by preparing a statement known as Funds Flow Statement, also known as Sources and Application of Funds Statement or the Statement of Changes in Financial Position. There is no prescribed form in which the statement should be prepared. However, it is customary to draw it in a manner as would disclose the main sources of funds and their uses. It shows the various sources and uses of funds during a year. Some of those sources and application are listed below:

Sources of Funds:

(i) Issue of shares and debentures for cash: If shares or debentures are issued at par, the paid-up value constitutes the source of fund. If shares/debentures are issued at a premium, such premium is to be added and if shares/debentures are issued at a discount, such discount is to be subtracted to determine the source of fund.

But issue of bonus shares, conversion of debentures into equity shares or shares issued to the vendors in case of business purchases do not constitute sources of fund.

(ii) Long-term Loans: Amount of long-term loan raised constitutes source of fund. But if a long-term loan is just renewed for an old loan, then the money received by such renewal becomes the source.

(iii) Sale of investments and other fixed assets: Sale proceeds constitute a source of fund.

An old machine costing ₹ 8 Lacs, W.D.V. ₹ 2 Lacs was sold for ₹ 1.75 Lacs. Here source of fund was only ₹ 1.75 lakhs.

(iv) Fund from Operations: Fund generated from operations is calculated as below:

Net Income:

Additions:

1. Depreciation of fixed assets
2. Amortization of intangible and deferred charges (i.e. amortization of goodwill, trademarks, patent rights, copyright, discount on issue of shares and debentures, on redemption of preference shares and debentures, preliminary expenses, etc.)
3. Amortization of loss on sale of investments
4. Amortization of loss on sale of fixed assets
5. Losses from other non-operating items
6. Tax provision (created out of current profit)
7. Proposed dividend
8. Transfer to reserve

Subtraction:

1. Deferred credit (other than the portion already charged to Profit & Loss A/c)
2. Profit on sale of investment
3. Profit on sale of fixed assets
4. Any subsidy credited to P & L A/c.
5. Any written back reserve and provision.

Here, Fund from Operations, is calculated after adding back tax provision and proposed dividend. Students should note that if provision for taxation and proposed dividend are excluded from current liabilities, then only these items are to be added back to find out the 'Fund from Operations'. By fund from operations if we want to mean gross fund generated before tax and dividend, then this concept is found useful. At the same time, fund from operations may also mean net fund generated after tax and dividend. For explaining the reasons for change in fund it would be better to follow the gross concept.

(v) Decrease in Working Capital: It is just for balancing the Fund Flow Statement. This figure will come from change in working capital statement.

Applications of Funds:

(i) Purchase of fixed assets and investments: Cash payment for purchase is application of fund. But if purchase is made by issue of shares or debentures, such will not constitute application of fund. Similarly, if purchases are on long term credit (because short term credit of less than 12 months is a current liability and considered in working capital calculation), these will not constitute fund applications.

(ii) Redemption of debentures, preference shares and repayment of loan: Payment made including premium (less: discount) is to be taken as fund applications.

(iii) Payment of dividend and tax: These two items are to be taken as applications of fund if provisions are excluded from current liabilities and current provisions are added back to profit to determine the 'Fund from Operations'.

(v) Increase in working capital: It is the balancing figure. This figure will come from change in working capital statement.

Analysis of Funds Flow Statement

Fund Flow Statement is prepared to explain the change in the working capital position of a business.

Particularly there are two flows of funds (inflow):

a) Long term fund raised by issue of shares, debentures or sale of fixed assets and

b) Fund generated from operations which may be taken as a gross before payment of dividend and taxes or net after payment of dividend and taxes.

Applications of fund are for investment in fixed assets or repayment of capital.

If long-term fund requirement is met just out of long-term sources, then the whole fund generated from operations will be represented by increase in working capital. On the other hand, if fund generated from operations is not sufficient to bridge a gap of long-term fund requirement, then there will be a decline in working capital.

Benefits of Funds Flow Statement

Funds flow statement is useful for long term analysis. It is a very useful tool in the hands of management for judging the financial and operating performance of the company. The balance sheet and profit and loss account failed to provide the information which is provided by funds flow statement i.e., changes in financial position of an enterprise. Such an analysis is of great help to management, shareholders, creditors, brokers etc.

1. The funds flow statement helps in answering the following questions:

   (a) Where have the profits gone?

   (b) Why there is an imbalance existing between liquidity position and profitability position of the enterprise?

(c) Why is the concern financially solid in spite of losses?

2. A projected funds flow statement can be prepared and resources can be properly allocated after an analysis of the present state of affairs The optimal utilisation of available funds is necessary for the overall growth of the enterprise. The funds flow statement prepared in advance gives a clear-cut direction to the management in this regard. The projected funds flow statement can be prepared and budgetary /capital expenditure control can be exercised in the organisation.

3. The funds flow statement analysis helps the management to test whether the working capital has been effectively used or not and whether the working capital level is adequate or inadequate for the requirement of business. The working capital position helps the management in taking policy decisions regarding dividend etc.

4. The funds flow statement analysis helps the investors to decide whether the company has managed funds properly. It also indicates the credit worthiness of a company which helps the lenders to decide whether to lend money to the company or not. It helps management to take policy decisions and to decide about the financing policies and capital expenditure programme for future.

Funds Flow Statement versus Cash Flow Statement

Both funds flow and cash flow statements are used in analysis of past transactions of a business firm. The differences between these two statements are given below:

(a) Funds flow statement is based on the accrual accounting system. In case of preparation of cash flow statements all transactions effecting the cash or cash equivalents only is taken into consideration.

(b) Funds flow statement analyses the sources and application of funds of long-term nature and the net increase or decrease in long-term funds will be reflected on the working capital of the firm. The cash flow statement will only consider the increase or decrease in current assets and current liabilities in calculating the cash flow of funds from operations.

(c) Funds Flow analysis is more useful for long range financial planning. Cash flow analysis is more useful for identifying and correcting the current liquidity problems of the firm.

(d) Funds flow statement tallies the funds generated from various sources with various uses to which they are put. Cash flow statement starts with the opening balance of cash and reach to the closing balance of cash by proceeding through sources and uses.

Financial Analysis and its Tools

For the purpose of obtaining the material and relevant information necessary for ascertaining the financial strengths and weaknesses of an enterprise, it is necessary to analyse the data depicted in the financial statement. The financial manager has certain analytical tools which help in financial analysis and planning. The main tools are Ratio Analysis and Cash Flow Analysis.

Ratio Analysis

The ratio analysis is based on the fact that a single accounting figure by itself may not communicate any meaningful information but when expressed as a relative to some other figure, it may definitely provide some significant information. Ratio analysis is not just comparing different numbers from the balance sheet, income statement, and cash flow statement. It is comparing the number against previous *years,* other companies, the industry, or even the economy in general for the purpose of financial analysis. The ratios can be classified into (i) Liquidity Ratios, (ii) Capital Structure/Leverage Ratio, (iii) Activity Ratios and (iv) Profitability Ratios. Ratio analysis is relevant in assessing the performance of a firm in respect of Liquidity Position, Long-term Solvency, Operating Efficiency and Overall Profitability.

CHAPTER 10

Issue, Forfeiture and Re-Issue of Shares

Introduction

Funds provided by the owner (s) into a business are recorded as capital. Capital of the business depends upon the form of business organization. Proprietor provides capital in a sole-proprietorship business. In case of a partnership, there is more than one proprietor, called partners. Partners introduce capital in a partnership firm. As the maximum number of members in a partnership firm is restricted, therefore only limited capital can be provided in such form of business. Moreover, the liability of the proprietor (s) is unlimited in case of non-corporate business, namely, sole-proprietorship and partnership.

With the onset of industrial revolution, requirement of capital investment soared to a new height and the attached risk of failure increased due to pace of technological developments. Non-corporate entities could not cope with the pressure of increased capital and degree of risk involved. This led to the emergence of corporate form of organisation.

Share Capital

Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share. The fixed value of a share, printed on the share certificate, is called nominal/par/face value of a share. However, a company can issue shares at a price different from the face value of a share. The liability of holder of shares (called shareholders) is limited to the issue price of shares acquired by them.

As per SEBI guidelines, a company is free to price its issue, if it has a three years track record of consistent profitability and in case of new company, if it is promoted by a company with a five years track record of consistent profitability. As the total capital of the company is divided into shares, the capital of the company is called Share Capital.

Share capital of a company is divided into following categories:

(i) Authorised Share Capital: A company estimates its maximum capital requirements. This amount of capital is mentioned in 'Capital Clause' of the 'Memorandum of Association' registered with the Registrar of Companies. It puts a limit on the amount of capital, which a company is authorized to raise during its lifetime and is called 'Authorised Capital'. It is also referred to as 'Registered Capital' or Nominal Capital'. It is shown in the balance sheet at face value.

(ii) Issued Share Capital: A company need not issue total authorized capital. Whatever portion of the share capital is issued by the company, it is called 'Issued Capital'.

Issued capital means and includes the nominal value of shares issued by the company for:

(1) Cash, and

(2) Consideration other than cash to:

  (a) Promoters of a company; and

  (b) Others.

It is also shown in the balance sheet at nominal value.

The remaining portion of the authorized capital which is not issued either in cash or other consideration may be termed us '**Un-issued Capital**'. It is not shown in the balance sheet.

(iii) Subscribed Share Capital: It is that part of the issued share capital, which is subscribed by the public i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.

(iv) Called-up Share Capital: Companies generally receive the issue price of shares in instalments. The portion of the issue price of shares which a company has demanded or called from shareholders is known as 'Called-up Capital' and the balance, which the company has decided to demand in future may be referred to as Uncalled Capital.

(v) Paid-up Share Capital: It is the portion of called up capital which is paid by the shareholders. Whenever a particular amount is called by the company and the shareholder(s) fails to pay the amount fully or partially, it is known as 'Unpaid calls' or 'instalments (or Calls) in Arrears'. Thus, instalments in arrears mean the amount not paid although it has been demanded by the company as payment towards the issue price of shares. To calculate paid-up capital, the amount of instalments in arrears is deducted from called up capital. In balance sheet, called-up and paid-up capital are shown together.

(vi) <u>Reserve Share Capital</u>: A company may decide by passing a special resolution that a certain portion of its subscribed uncalled capital shall not be called up except in the event of winding up of the company. Portion of the uncalled capital which a company has decided to call only in case of liquidation of the company is called Reserve Liability/Reserve Capital.

Reserve Capital is different from Capital reserve, Capital reserves are part of 'Reserves and Surplus' and refer to those reserves which are not available for declaration of dividend. These reserves may be used to write off capital losses such as discount on issue of shares. These can also be used to issue bonus shares, subject of the condition, that reserve is realized in cash. Thus reserve capital which is portion of the uncalled capital to be called up in the event of winding up of the company is entirely different in nature from capital reserve which is created out of capital profits only.

Illustration 1

A company had a registered capital of ₹ 1,00,000 divided into 10,000 equity shares of ₹ 10 each. It decided to issue 6,000 shares for subscription and received applications for 7,000 shares. It allotted 6,000 shares and rejected remaining applications. Upto 31-12-2011, it has demanded or called ₹ 9 per share. All shareholders have duly paid the amount called, except one shareholder, holding 500 shares who has paid only ₹ 7 per share.

Prepare a balance sheet assuming there are no other details.

Solution:

Balance Sheet as at December, 2011

Particulars	Notes No.	₹
EQUITY AND LIABILITIES		
Shareholders' funds		
Share capital	1	53,000
Total		53,000
ASSETS		
Current assets		
Cash and cash equivalents	2	53,000
Total		53,000

Notes to accounts

1	Share Capital		
	Equity share capital		
	Authorised share capital		
	10,000 Equity shares of ₹ 10 each	1,00,000	
	Issued share capital		
	6,000 Equity shares of ₹ 10 each	60,000	
	Subscribed share capital		
	6,000 Equity shares of ₹ 10 each	60,000	
	Called up and Paid up share capital		
	6,000Equity shares of ₹ 10 each ₹ 9 Called up	54,000	
	Less: Calls unpaid on 500 shares @ ₹ 2 per share	(1,000)	53,000
2	Cash and cash equivalents		
	Balances with banks		53,000

It is clear from above, that details of authorized, issued and subscribed capital are given in the Notes to Accounts but are not counted. It is only the paid-up capital i.e., the portion of the issued capital subscribed by shareholders which is taken into account while totalling the liabilities side of the balance sheet.

Types of Shares

Share issued by a company can be divided into preference shares and equity shares. Persons holding preference shares, called preference shareholders, are assured of a preferential dividend at a fixed rate during the life of the company. They also carry a preferential right over other shareholders to be paid first in case of winding up of the company.

A. Preference Shares

Thus, preference shareholders enjoy preferential rights in the matter of (a) Payment of dividend, and (b) Repayment of capital

Generally, holders of these shares do not get voting rights. Companies use this mode of financing as it is cheaper than raising debt. Dividend is generally cumulative in nature and need not be paid every year in case of deficiency of profits.

Types of Preference Shares

Preference shares can be of various types, which are as follows:

(a) **Cumulative Preference Shares**: A cumulative preference share is one that carries the right to a fixed amount of dividend or dividend at a fixed rate. Such a dividend is payable even out of future profit if current year's profits are insufficient for the purpose. This means that dividend on these shares accumulates unless it is paid in full and therefore, the shares are called Cumulative Preference Shares. The arrears of dividend are then shown in the balance sheet as a contingent liability. In India, a preference share is always cumulative unless otherwise stated. In case, the dividend remains in arrears for a period of not less than two years, holders of such shares will be entitled to take part and vote on every resolution on every matter in the general body meeting of the shareholders

(b) **Non-cumulative Preference Shares**: A non-cumulative preference share carries with it the right to fixed amount of dividend. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires. It implies that holder of such a share is not entitled to arrears of dividend in future. (This was the provision of Section 87 of the companies Act 1956. However, there is no corresponding provision in Section 47 of Companies Act 2013).

(c) **Participating Preference Shares**: Notwithstanding the right to a fixed dividend, this category of preference share confers on the holder the right to participate in the surplus profits, if any, after the equity shareholders have been paid dividend at a stipulated rate. Similarly, in the event of winding up of the company, this type of share carries the right to receive a pre-determined proportion of surplus as well once the equity shareholders have been paid off.

(d) **Non-participating Preference Shares**: A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares.' Unless otherwise specified, the preference shares are generally non-participating.

(e) **Redeemable Preference Shares**: These are shares that a company may issue on the condition that the company will repay after the fixed period or even earlier at Companies discretion. The repayment on these shares is called redemption and is governed by the provisions in the Act. In India, Companies can now issue only this category of preference shares.

(f) **Non-redeemable Preference Shares**: The preference shares, which do not carry with them the arrangement regarding redemption, are called Non-redeemable Preference Shares. According to the Act, no company limited by shares shall issue irredeemable preference shares or preference shares redeemable after the expiry of 20 years from the date of issue.

(g) **Convertible Preference Shares**: These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.

(h) **Non-convertible Preference Shares**: When the holder of a preference share has not been conferred the right to get his holding converted into equity share, it is called Non-convertible Preference shares. Preference shares are non-convertible unless otherwise stated.

2. Equity Shares

Equity shares are those shares, which are not preference shares. It means that they do not enjoy any preferential rights in the matter of payment of dividend or repayment and may vary from year to year. Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders. These shares carry voting rights. The Act permits issue of equity share capital with differential rights as to dividend, voting or otherwise.

The shares can be issued by a company either

- For cash or
- For consideration other than cash

Issue of Shares for Cash

To issue shares, private companies depend upon 'Private Placement' of shares. Public companies issue a 'Prospectus' and invite general public to subscribe for shares. To discuss accounting treatment, we shall concentrate on public companies who invite general public to subscribe for equity shares. Similar accounting treatment is applicable in other cases. However, for journal entries in case of issue of preference shares, the word 'Equity' is replaced with the word 'Preference'. A public company issues a prospectus inviting general public to subscribe for its shares. On the basis of prospectus, applications are deposited in a scheduled bank by the interested parties along with the amount payable at the time of application, in cash. First instalment paid along with application is called 'Application Money'. Application money must be at least 5% of the face value of shares.

Minimum Subscription: A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company. The amount of minimum subscription is to be disclosed in prospectus by the Board of Directors taking into account the following:

a) Preliminary expenses of the company,

b) Commission payable on issue of shares,

c) Cost of fixed assets purchased or to be purchased,

d) Working capital requirements of the company, and

e) Any other expenditure for the day to day operation of the business.

As per guidelines of the Securities Exchange Board of India (SEBI), a company must receive a minimum of 90% subscription against the entire issue (including devolvement on underwriters in case of underwritten issue) before making any allotment of shares or debentures to the public. It is applicable for public and right issue, and not in case of offer for sale of securities. If the Company does not receive the minimum subscription of 90% of the issue, the entire subscription shall be refunded to the applicants within 15 days after the date of closure of issue. In case of delayed refund, interest for the delayed period shall be payable.

The Company reserves the right to reject or accept an application fully or partially. Successful applicants become shareholders of the company and are required to pay the second installment which is known as 'Allotment Money' and unsuccessful applicants get back their money. However, in case of delay in refunding the money, the Company becomes liable to pay interest ranging from 4% to 15% (having regard to the length of the period in delay) on the amount of refund. Subsequent installments, if any, to be called by the company are known as 'Calls'. The Act requires that the period of at least one month must be there between two calls. The Securities and Exchange Board of India (SEBI) Guidelines, require the shares issued are made fully paid up within twelve months of the date of allotment if size of the issue is up to 500 crores.

As per provisions of the Act application money must be at least 5% of the face value of shares. However, as per SEBI Guidelines, the minimum application moneys to be paid by an applicant along with the application shall not be less than 25% of the issue price. According to the Act, matters related to issue and transfer of securities will be administered by the SEBI and not by the Company Law Board.

The issue price of shares is generally received by the company in instalments and these instalments are known as under:

First instalment	…………	Application Money
Second Instalment	…………	Allotment Money
Third Instalment	…………	First Call Money
Fourth Instalment	…………	Second Call Money and so on.
Last Instalment		Final Call money

Journal Entries for Issue of Shares for Cash

Upon the issue of share capital by a company, the under mentioned entries are made in the financial books:

(1)	On receipt of the application money		
	Bank Account		Dr. (with the actual amount received)
	To share Application Account		

(2)	On allotment of share		
	Share Allotment Account		Dr. (with the amount due on allotment)
	Share Application Account		Dr. (with application amount received on allotted share)
	To Share Capital Account		(with amount due on allotment and application)
(3)	On receipt of allotment money		
	Bank Account		Dr. (with the amount received on allotment)
	To Share Allotment Account		
	Sometimes separate Application and Allotment Accounts are not prepared and entries relating to application and allotment monies are passed through a combined Application and Allotment Account.		
(4)	On a call being made		
	Share Call Account		Dr. (with the amount due on the cal)
	To Share Capital Account		
(5)	On receipt of call money		
	Bank Account		Dr. (with the due amount received on call)
	To Share Call Account		

Subscription of Shares

Accounting for issue of shares depends upon the type of subscription. Whenever a company decides to issue shares to public, it invites applications for subscription by issuing a prospectus. It is not necessary that company receives applications for the number of shares to be issued by it. There are three possibilities:

Full Subscription

Issue is fully subscribed if the number of shares offered for subscription and the number of shares actually subscribed by the public are same. To start discussion on accounting treatment for issue of shares, let us assume that the issue is fully subscribed.

Illustration 2

A company invited applications for 10,000 equity shares of ₹ 50 each payable on application ₹ 15, on Allotment ₹ 20, on first and final call ₹ 15. Applications are received for 10,000 shares and all the applicants are allotted the number of shares they have applied for and installment money was duly received by the company. Show Journal entries in the books of the company.

Solution:

Journal entries in the books of a company

For application money received: Amount received along with application is accounted as follows:

Bank Account Dr. (Application money allotted share i.e.
To Equity Share Application Account 10,000 x 15 = 1,50,000)

At the time of allotment: Application money received from successful applicants become part of share capital and is transferred to share capital as under:

Equity Share Application A/c Dr. (Application money on allotted share i.e.,
To Share Capital A/c 10,000 x 15 =1, 50,000)

To record amount due on allotment: When the decision is taken to allot shares, allotment money on allotted shares falls due and is recorded as follows:

Equity Share Allotment A/c Dr. (Application due at the allotted share i.e.,
To Share Capital A/c 10,000 x 20 = 2,00,000)

For allotment money received:

Allotment money received from shareholders is recorded as follows:

Bank A/c Dr. (Allotment money received from shareholders i.e.)
To Equity Share Allotment A/c (10,000 x 20 = 2,00,000)

When decision to demand first call is made: After allotment of share, when the Board of Directors decide to demand the next instalment from shareholders, first call money falls due and is accounted for, as under:

Equity Share First and Final Call A/c Dr. (No of share x first call money per share i.e.
To Equity Share Capital A/c 10,000 x 15 = 1,50,000)

On receiving first and final call money: The journal entry passed to record the money received on account of first call is as under:

Bank A/c Dr. (Amount actually received on account of first call i.e.
To Equity First and Final Call A/c 10,000 x 15 = 1,50,000

Undersubscription

It means the number offered for subscription is more than the number of shares subscribed by the public. In this case, the journal entries as discussed above are passed but with one change i.e., calculation of application, allotment and for that matter, the call money is based on number of shares actually applied and allotted. It must be remembered that shares can be allotted, in this case, only when the minimum subscription is received.

Illustration 3

On 1st April, 2010, A Ltd. Issued 43,000 shares of ₹ 100 each payable as follows:

₹ 20 on application;

₹ 30 on allotment;

₹ 25 on 1st October, 2010; and

₹ 25on 1st February, 2011.

By 20th May, 40,000 shares were applied for and all applications were accepted. Allotment was made on 1st June. All sums due on allotment were received on 15th July; those on 1st call were received on 20th October. Journalise the transactions when accounts were closed on 31st March, 2011.

Solution:

	A Ltd Journal			
2010			Dr. ₹	Cr. ₹
May 20	Bank Account	Dr.	8,00,000	
	To Share Application & Allotment A/c			8,00,000
	(Application money on 40,000 shares at ₹ 20 Per share)			
June 1	Share Application& Allotment A/c	Dr.	20,00,000	
	To Share Capital A/c			20,00,000
	40,000 shares at ₹ 50 per share ₹ 20 on Application and ₹ 30 on allotment.			
	Directors resolution no … dated …)			
July 15	Bank Account	Dr.	12,00,000	
	To Share Application and Allotment A/c			12,00,000
	(The sums due on allotment received.)			
Oct. 1	Share First Call Account	Dr.	10,00,000	
	To Share Capital Account			10,00,000
	First call-on 40,000 shares at ₹ 25 per Directors, resolution no … dated …)			
Oct. 20	Bank Account	Dr.	10,00,000	
	To Share First Call Account			10,00,000
	(Receipt of the amounts due on first call.)			
2011				

Feb. 1	Share Second and Final Call A/c	Dr.	10,00,000	
	To Share Capital A/c			10,00,000
	(Amount due on 40,000 share at ₹ 25 Per share on second and final call, as per Director's resolution no …. Dated ….)			
Mar. 31	Bank Account	Dr.	10,00,000	
	To Share Second & Final Call A/c			10,00,000
	(Amount received against the final call on 40,000 shares at ₹ 25 per share.)			

Over Subscription

In actual practice, issue of shares is either under or over-subscribed. If an issue is over-subscribed, some applications may be rejected and application money refunded and in respect of others, only a part of the shares applied for may be allotted and the excess amount received can be utilized towards allotment or call money which has fallen due or will soon fall due for payment.

The entries are:

(1)	On refund of application money to applicants to whom shares have not been allotted:	
	Share Application A/c	Dr.
	To Bank Account	
(2)	When only a part of shares applied for are allowed:	
	Share Application A/c	Dr. (with the amount received in advance for allotment)
	To share Allotment A/c	
	To Share Calls-in-Advance A/c	

Illustration 4

The Delhi Artware Ltd. issued 500 equity shares of ₹ 100 each and 1,000 preference shares of ₹ 100 each. The share capital was to be collected as under:

	Equity Shares ₹	Preference Shares ₹
On Application	25	20
On Allotment	20	30
First Call	30	20
Final Call	25	30

All these were subscribed. Final call was received on 420 equity shares and 880 preference shares. Prepare the cash book and journalise the remaining transactions in the books of the company.

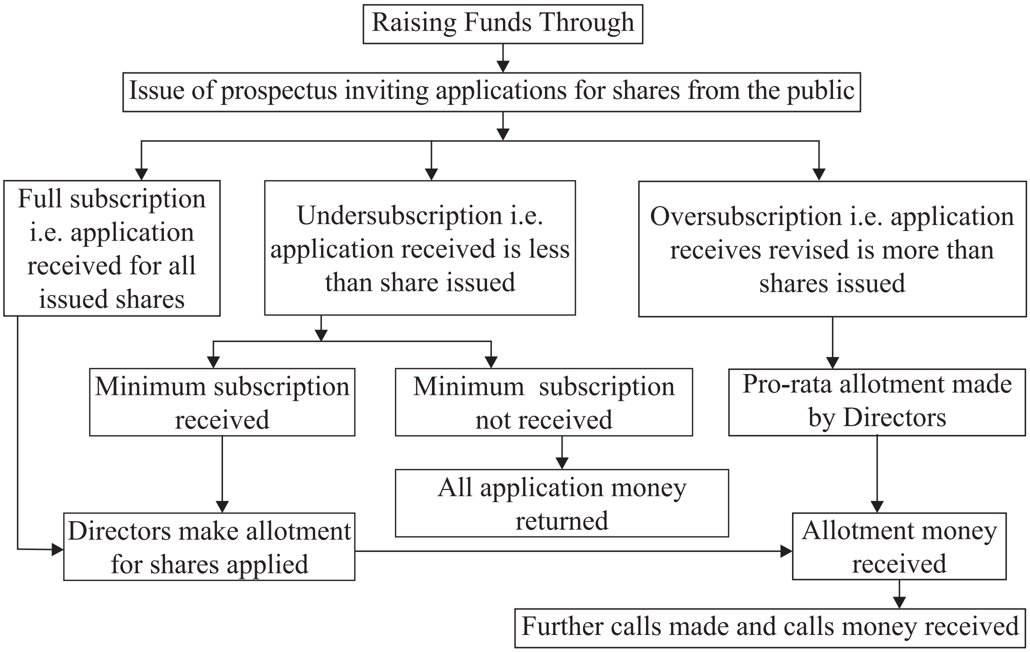
Solution:

	Delhi Artware Ltd. Cash Book			
Dr.		₹		Cr. ₹
To	Equity Shares Application &		By Balance c/d	1,44,400
	Allotment Account (application			
	Money on 500 shares at ₹ 25)	12,500		
To	Preference Share Application &			
	Allotment A/c (application money			
	On 1,000 share at ₹ 20)	20,000		
To	Equity share Applications &			
	Allotment A/c (allotment money			
	On 500 shares at ₹ 20)	10,000		
To	Preference Share Application &			
	Allotment A/c (allotment money			
	On 1,000 shares at ₹ 30)	30,000		
To	Equity Shares First Call A/c			
	(₹ 30 on 500 shares)	15,000		
To	Preference Share first Call A/c			
	(₹ 20 on 1,000 shares)	20,000		
To	Equity shares Final Call A/c			
	(₹ 25 on 420shares)	10,500		
To	Preference Share Final A/c			
	(₹ 30 on 880 shares)	26,400		
		1,44,400		1,44,400
To	Balance b/d	1,44,400		

Journal		₹	₹
		Dr.	Cr.
Equity Share Application & Allotment A/c	Dr.	22,500	
To Equity share Capital A/c			22,500
Equity shares at ₹ 45 per share (₹ 25 on Application and ₹ 20 on allotment) allotted as Per Directors resolution no ….. dated….]			
Preference Share Application & Allotment A/c	Dr.	50,000	
To Preference Share Capital A/c			50,000
Of 1,000 preference shares at ₹ 50 per (₹ 20 on application and ₹ 30 on allotment), allotted as per Directors resolution no … dated …)			
Equity Share First Call A/c	Dr.	15,000	
To Equity Share Capital A/c			15,000
(Amount due on 500 equity shares at ₹ 30 per share as Per Directors resolution no … dated …)			
Preference Share First Call A/c	Dr.	20,000	
To Preference Share Capital A/c			20,000
(Amount due on 1,000 preference shares at ₹ 20			
Per share, as per Directors resolution no … dated …)			
Equity Share final Call A/c	Dr.	12,500	
To Equity share Capital A/c			12,500
(Amount due on final call on 500 equity shares at ₹ 25 per share, as per Directors resolution … dated …)			
Preference Share Final Call A/c	Dr.	30,000	
To preference Share Capital A/c			30,000
(Amount due on final call on 1,000 preference shares At ₹ 30 per share, as per Directors resolution no ...dated.)			

Notes: Students may note that cash transactions have not been journalized as these have been entered in the Cash Book.

An overview of the procedure for raising funds through equity can be depicted with the help of following chart:



Shares issued at Discount

There are instances when the shares of a company can also be issued at a discount, i.e., at an amount less than the nominal or par value of shares. The excess of the nominal value over the issue price represents discount on the issue of shares. For example, when a share of the nominal value of ₹ 100 is issued at ₹ 98, it is said to have been issued at a discount of 2 percent.

According to the provisions (Section 53 and 54) of the companies Act 2013 a company is not permitted to issue shares at a discount except sweat equity shares of a class of shares already issued provided the following conditions are satisfied:

(a) The issue of shares at a discount is authorized by a special resolution passed by the company at its general meeting and sanctioned by the Central government.

(b) The resolution must specify number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued.

(c) At least one year must have elapsed since the company had commenced the business.

(d) The shares are of a class, which has already been issued.

Accounting Treatment

Whenever shares are issued at a discount the amount of discount is brought into the books at the time of allotment by debiting an account called "Discount on the issue of shares account". Therefore, the journal entry to record discount on the issue of shares is as given below:

Share Allotment A/c Dr.

Discount on the issue of Shares A/c Dr.

(Amount due on allotment of _Shares @ ₹ _)

'Discount on the Issue of Shares Account', showing a debit balance, denotes a loss to the company, which is in the nature of capital loss.

Therefore, the account is presented on the asset side of the Companies balance sheet under "Other current/Non-current Asset" depending upon the amortization period. It is written off by charging it to the Securities Premium Account of any, and, in its absence, by charging to the Profit and Loss Account over a period of time.

Illustration 5

DM Limited issued 25,000 Equity Shares of ₹ 20 each, at a discount of 10 per cent, payable as follows:

On Application	₹ 5 per share
On Allotment	₹ 6 per share
On First Call	₹ 7 per share

Applications were received for 37,500shares and the Directors made pro-rata allotment to the applicants for 30,000 shares.

Record journal entries for above transactions in the books of the Company.

Solution:

Books of DM Limited - Journal

Particulars	L.F.	Debit Amount ₹	Credit Amount ₹
Bank A/c Dr.		1,87,500	
To Equity Share Application A/c			1,87,500
(Money received on applications for 37,500 shares @ ₹ 5 per share)			
Equity share application A/c Dr.		1,87,500	

To Equity Share Capital A/c			1,25,000
To Equity Share Allotment A/c			25,000
To Bank A/c			37,500
(Transfer of application money on shares allotted to share capital, excess application amount adjusted to allotment and money refunded on rejected applications)			
Equity Share Allotment A/c Dr.		1,50,000	
Discount on Issue of Shares A/c Dr.		50,000	
To Equity share capital A/c			2,00,000
(Amount due on the allotment of 25,000 shares			
@ ₹ 6 per share and discount on issue brought Into account)			
Bank A/c Dr.		1,25,000	
To Equity Share allotment A/c			1,25,000
(Money received consequent upon allotment)			
Equity Share First call A/c Dr.		1,75,000	
To Equity share Capital A/c			1,75,000
(First call money due on 25,000 shares @ ₹ 4 per share)			
Bank A/c Dr.		1,75,000	
To Equity Share First Call A/c			1,75,000
(Money received on first call)			

(i) application money received ₹ 1,87,500	₹ 5 x 37,500 = 1,87,500
(ii) amount refunded for 7,500 shares	₹ 5 x 7,500 = 37,500
(iii) amount to be adjusted on allotment	(30,000-25,0000) x ₹ 5
	₹ x 5,000 = 25,000

A company can issue shares at a discount subject to the provision contained in Act. Whenever shares are issued at a discount, Application and Allotment of call Account is debited only with the net amount due and the discount allowed is debited to the Discount on Issue of shares Account and credited to Share Capital Account to make up the nominal amount of shares subscribed. The discount on shares, till the same is written off, is shown as ‘other non-current asset’ in the Balance Sheet.

Accounting Treatment

When a Company issued its securities at a price more than the face value, it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security. It is quite common for the financially strong, and well-managed companies to issue their shares at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, where a share of the nominal value of ₹ 100 is issued at ₹ 105, it is said to have been issued at a premium of 5 per cent.

When the issue is at a premium, the amount of premium may technically be called at any stage of share capital transactions. However, premium is generally called with the amount due on allotment, sometimes with the application of money and rarely with the call money.

When shares are issued at a premium, the premium amount is shown under the heading, "Reserves and Surplus". However, 'reserves and Surplus' is shown as' shareholder's funds in the Balance Sheet. According to provisions (Section 52) in the Act Securities Premium Account may be used by the company:

(a) In paying up un-issued securities of the company to be issued to members of the company as fully paid bonus securities.

(b) To write off preliminary expenses of the company.

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.

(d) To pay premium on the redemption of preference securities or debentures of the company.

(e) for the purchase of its own shares or other securities under Section 68.

When shares are issued at a premium, the journal entries are as follows:

(a) Premium amount called with Application money	
(i) Bank A/c Dr.	[Total Application money + Premium
To Share Application A/c	Amount received]
[Money received on applications for _Shares @ ₹ ___per Share including premium]	
(ii) Share Application A/c Dr.	[No of Shares Applied for x Application Amount per share]
To Securities Premium A/c	[No. of shares allotted x Premium Amount Per share]
To Share Capital A/c	[No. of Shares allotted x per share for capital]

(b) Premium Amount called with allotment Money	
(a) Share Allotment A/c Dr.	[No. of Shares allotted x Allotment and Premium Money per share]
To Share Capital A/c	[No. of shares Allotted x Allotted Amount per share]
To Securities Premium A/c	[No. of Shares allotted x premium Amount per share]
(Amount due on allotment of shares @ ₹ _____ per share Including premium)	
(ii) Bank A/c Dr.	
To Share Allotment A/c	
(Money received including premium consequent upon allotment).	

Illustration 6

Pioneer Equipment Limited received on October 1, 2011 applications for 25,000 Equity Shares for ₹ 100 each to be issued at a premium of 25 per cent payable at thus:

On application	₹25
On allotment	₹75 (including premium)
Balance amount on shares	As and when required

The shares were allotted by the Company on October 20, 2011 and the allotment money was duly received on October 31, 2011.

Record journal entries in the books of the company to capture the transactions related to issue of shares.

Solution

Pioneer Equipment Limited Journal					
Date 2011	Particulars		L.F	Debit Amount ₹	Credit Amount ₹
Oct. 1	Bank A/c	Dr.		6,25,000	
	To Equity Share Application A/c				6,25,000
	(Money received on applications for 25,000 shares @ ₹ 25 per share)				

Oct. 20	Equity Share Application A/c	Dr.		6,25,000	
	To Equity Share Capital A/c				6,25,000
	(Transfer of application money on Allotment to share capital)				
Oct. 20	Equity Share Allotment A/c	Dr.		18,75,000	
	To Equity Share Capital A/c				12,50,000
	To Securities premium A/c				6,25,000
	(Amount due on allotment of 25,000 Shares @ ₹ 75 per share including premium)				
Oct. 31	Bank A/c	Dr.		18,75,000	
	To Equity Share Allotment A/c				18,75,000
	(Money received including premium consequent open allotment)				

Illustration 7

X Ltd. Invited applications for 10,000 shares of ₹ 100 each payable as follows:

On Application	₹ 20
On Allotment (on 1st May, 2010)	30
On First Call (On 1st Oct., 2010)	30
On Final Call (on 1st Feb., 2011)	20

All shares were applied for and allotted. A shareholder holding 200 shares paid the whole of the amount due along with allotment. Journalize the transactions, assuming all sums due were received. Interest was paid to the shareholder concerned on 1st February, 2011.

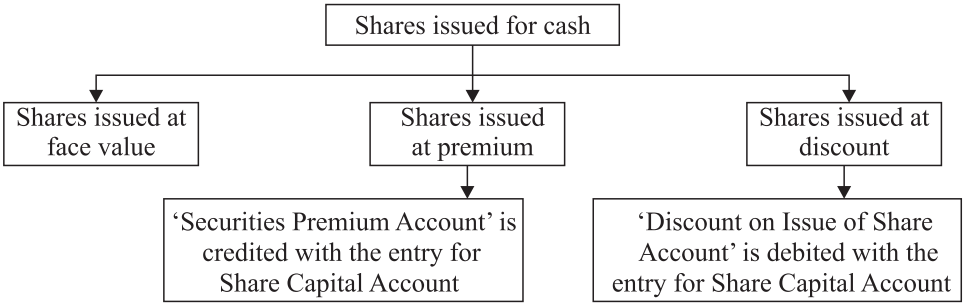
Solution:

Journal of X Ltd.				
2010			Dr. ₹	Cr. ₹
May 1	Bank A/c	Dr.	2,00,000	
	To Shares Application & Allotment A/c			2,00,000
	(Receipt of applications for 10,000 shares along with application money of ₹ 20 per share)			
May 1	Share Application and Allotment A/c	Dr.	5,00,000	

	To share Capital A/c			5,00,000
	Application ₹ 20 and on allotment ₹ 30 per Share, as per Directors resolution no … dated …)			
May 1	Bank A/c	Dr.	3,10,000	
	To Shares Application & Allotment A/c			3,00,000
	To Calls in Advance A/c			10,000
	[Receipt of money due on allotment, also the Two calls (₹ 30 and ₹ 20) on 200 shares.]			
Oct. 1	Bank A/c	Dr.	2,94,000	
	Calls in Advance A/c	Dr.	6,000	
	To Share First Call A/c			3,00,000
	(Receipt of the first call on 9,800 shares, the balance having been previously received and now debited to call in advance account.)			
2011				
Feb. 1	Share Final Call A/c	Dr.	2,00,000	
	To Share Capital A/c			2,00,000
	(The amount due on Final Call on 10,000 shares @ ₹ 20 per share, as per Directors resolution No… dated …)			
Feb. 1	Bank A/c	Dr.	1,96,000	
	Calles in Advance A/c	Dr.	4,000	
	To Share Final A/c			2,00,000
	(Receipt of the moneys due on Final call on 9,800 shares, the balance having been previously received.)			
Feb. 1	Interest A/c	Dr.	330	
	To Bank A/c			330
The Interest on calls in advance paid @ 6 % on : ₹ 6,000 (first call) from 1st May to 1st Oct., 2010-5 months ₹ 4,000 (final call) from 1st May to 1st Feb., 2011-9 months		150 180		
		330		

Shares can be issued either at face value or at premium or at discount.

The following chart depicts the three categories as follows:



Over Subscription and Pro-Rata Allotment

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

For example, a company offers to the public 10,000 shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis, applicants for12,000 shares are to be allotted 10,000 shares, i.e., on the 12,000 : 10,000 or 6:5 ratio. Any applicant who has applied for 6 shares will be allotted 5 shares.

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

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

Accounting Entries			
(a)	For rejected application: Share Application Account To Bank Account	Dr.	
(b)	For pro-rata allotment: Share Application Account To Share Allotment Account	Dr	

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

Illustration 8

JHP Limited is a company with an authorized share capital of 10,00,000 in equity shares of ₹ 10 each, of which 6,00,000 shares had been issued and fully paid on 30th June, 2010. The Company proposed to make a further issue of 1,00,000 of these ₹ 10 shares at a price of ₹ 14 each the arrangements for payment being:

(a) ₹ 2 per share payable on application, to be received by 1st July, 2010;

(b) Allotment to be made on 10th July, 2010 and a further ₹ 5 per share (including the premium) to be payable;

(c) The final call for the balance to be made, and the money received by 30th April, 2011.

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

(i) Applicants for 5,000 shares received allotment in full;

(ii) Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment;

(iii) Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and

(iv) The money due on final call was received on the due date.

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

Solution

	<u>Journal of JHP Limited</u>			
Date 2010	Particulars		Dr. ₹	Cr. ₹
	Bank A/c (Note 1 – Column 3)	Dr.	7,10,000	

July 1	To Equity Share Application A/c			7,10,000
	(Being application money received on 3,55,000			
	Shares @ ₹ 2 per share)			
July 10	Equity Share Application A/c	Dr.	7,10,000	
	To Equity Share Capital A/c			2,00,000
	To Equity Share Allotment A/c			4,30,000
	(Note 1 Column 5)			
	To Bank A/c (Note 1 – Column 6)			80,000
	(Being application money on 1,00,000 shares transferred to Equity Share Capital Account; on 2,15,000 shares adjusted with allotment and on 40,000 shares refunded as per Board's Resolution No. dated...)			
	Equity Share Allotment A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			1,00,000
	To Securities Premium a/c			4,00,000
	(Being allotment money due on 1,00,000 shares @ ₹ 5 each including premium as per Board's Resolution No… dated …)			
	Bank A/c (Note 1 – Column 8)	Dr.	70,000	
	To Equity Share Allotment A/c			70,000
	(Being balance allotment money received)			
2011	Equity Share Final Call A/c	Dr.	7,00,000	
	To Equity Share Capital A/c			7,00,000
	(Being final call money due on 1,00,000 Shares @ ₹ 7 per share as per Board's Resolution No …. Dated ….)			
April 30	Bank A/c		7,00,000	
	To Equity Share Final Call A/c			7,00,000
	(Being final call money on 1,00,000 shares @ ₹ 7 each received)			

Working Notes:

Calculation for Adjustment and Refund

Category	No. of Shares Applied for	No. of Shares Allotted	Amount Received on Application	Amount Required on Application	Amount adjusted on Allotment	Refund [3-4+5]	Amount due on Allotment	Amount received on Allotment
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(i)	5,000	5,000	10,000	10,000	-	Nil	25,000	25,000
(ii)	30,000	15,000	60,000	30,000	30,000	Nil	75,000	45,000
(iii)	3,20,000	80,000	6,40,000	1,60,000	4,00,000	80000	400,000	-
TOTAL	3,55,000	1,00,000	7,10,000	2,00,000	4,30,000	80000	500,000	70,000

At the time of receiving the value of share in instalments

At the time of receiving the value of share in instalments

- Share instalment money received in full → Bank A/c is debited with full money received
- Calls-in-arrears i.e. money received is less than due → 'Calls-in-arrears A/c' is debited with entry for 'Bank A/c'
- Calls-in-advance i.e. money of the future instalments received before hand → 'Calls-received in advance A/c' is credited with entry for 'Bank A/c'

Calls-in-Arrears

Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments in known as Calls-in-Arrears or Unpaid Calls. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

For recording 'Calls-in-Arrears', the following journal entry is recorded:

Calls-in-Arrears A/c	Dr [Amount of Unpaid Calls]
To Share Allotment A/c	
To Share Calls A/c	

The Articles of Association of company usually empower the directors to charge interest at a stipulated rate on calls-in-arrears. According to table F of Companies Act 2013 (Regulation 16 of Table F). Interest at the rate of 10 per cent per annum is to be charged on unpaid calls for the period intervening between the due date of the call and the time of actual payment. However, the directors have the authority to waive the application of this rule in individual cases at their discretion.

The journal entries for call-in-arrears are as follows:

(i)	For Interest receivable on calls-in-arrears		
	Shareholder Ac	Dr.	
	To Interest on calls-in-arrears A/c		
(ii)	For receipt of interest		
	Bank A/c	Dr.	
	To Shareholders A/c		

Calls-in-Advance

Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as calls-in-advance. According to table F of Companies Act 2013 (Regulation 18 of Table F) interest at the rate up to 12 percent is to be paid on such advance call money. This amount is credited in calls-in-advance Account.

The following entry is recorded:

Bank A/c	Dr.
To Call-in-Advance A/c	

When calls become actually due, Call-in-Advance account is adjust at the time of the call. For this the following journal entry is recorded:

Call-in-Advance A/c	Dr.	[Call amount due]
To Particular Call A/c		

The accounting treatment of interest on Call-in-Advance is as follows:

(i)	Interest Due	Dr.	[Amount of interest due for payment]
	To Shareholder's A/c		
(ii)	Payment of Interest		
	Shareholder's A/c	Dr.	[Amount of interest paid]
	To Bank A/c (interest paid on Call-in-Advance)		

Interest on Calls-in-Arrears and Calls-in-Advance

Interest on calls is arrear is recoverable and that in respect of calls in advance is payable, according to provisions in this regard in the articles of the company, at the rates mentioned therein or those to be fixed by the directors, within the limits prescribed by the Articles. Table F prescribes 10 % and 12 % p.a. as the maximum rates respectively for calls in arrears and those in advance.

Directors, however, have the right to waive the payment of interest on calls in -arrear. Calls received in advance are not entitled to any dividend. The book entries to be passed for the adjustment of such interest are much the same as those in case of temporary borrowings or loans raised, the only difference being that debits are raised and credits are given to Sundry Members Account (and not the individual accounts of shareholders) in respect of interest recoverable on calls in arrear or that payable on call received in advance, the corresponding entries being made in the Interest receivable on Calls in Arrears and Interest payable on Calls in Advance, respectively.

Illustration 9

Rashmi Limited issued at par 10,000 Equity shares of ₹ 10 each payable ₹ 2.50 on application; ₹ 3 on allotment; and balance on the final call. All the shares were fully subscribed and paid except a shareholder having 100 shares could not pay the final call. Give journal entries to record these transactions.

Solution:

	Book of Rashmi Limited Journal			
Date	Particulars	LF.	Debit Amount ₹	Credit Amount ₹
	Bank A/c Dr.		25,000	
	To Equity Share Application A/c			25,000
	(Money received on applications for 10,000 share @ ₹ 2.50 per share)			
	Equity Share Application A/c Dr.		25,000	
	To Equity Share Capital A/c			25,000
	(Transfer of application money on 10,000 Shares to share capital)			
	Equity Share Allotment A/c Dr.		30,000	
	To Equity Share Capital A/c			30,000
	(Amount due on the allotment of 10,000 Shares @ 3 per share)			
	Bank A/c Dr.		30,000	
	To equity Share Allotment A/c			30,000
	(Allotment money received)			

	Share Final Call A/c Dr.		45,000	
	To Equity Share Capital A/c			45,000
	(Final Call money due)			
	Bank A/c Dr.		44,550	
	Calls-in-Arrears A/c Dr.		450	
	To Share Final Call A/c			45,000
	(Final call money received and arrears On 100 shares)			

Illustration 10

A limited Company, with an authorized capital of ₹ 2,00,000 divided into shares of ₹ 100 each, issued for subscription 1,000 shares payable at ₹ 25 per share on application, ₹ 30 per share on allotment, ₹ 20 per share on first call three months after allotment and the balance as and when required.

The subscription list closed on January 31, 2011 when application money on 1,000 shares was duly received and allotment was made on 1 March,2011.

The allotment amount was received in full but, when the first call was made, one shareholder failed to pay the amount on 100 shares held by him and another shareholder with 50 shares paid the entire amount on his shares.

Give journal entries in the books of the Company to record these share capital transactions assuming that all amounts due were received within one month of the date they were called.

Solution:

Books of the Company
Journal

Date	Particulars	LF.	Debit amount ₹	Credit Amount ₹
Jan 31	Bank A/c Dr.		25,000	
	To equity share Application A/c			25,000
	(Money received on applications for 1,000 shares @ rupees 25 per share)			
Mar 1	Equity Share Application A/c Dr.		25,000	

	To Equity Share Capital A/c			25,000
	(Transfer of application money on 1,000 Share to share capital)			
Mar 1	Equity Share Allotment A/c		30,000	
	To Equity Share Capital A/c			30,000
	(Amount due on the allotment of 1,000 Share @ ₹ 30 per share)			
Apr 1	Bank A/c Dr.		30,000	
	To Equity Share Allotment A/c			30,000
	(Allotment money received)			
Jun 1	Equity Share First Call A/c Dr.		20,000	
	To Equity Share Capital A/c			20,000
	(First call money due on 1,000 shares @ ₹ 20 per share)			
Jul 1	Bank A/c Dr.		19,250	
	Calls-in-Arrears A/c		2,000	
	To Equity Share First Call A/c			20,000
	To Call-in-Advance A/c			1,250
	(First call money received on 900 Shares and calls-in-advance on 50 shares @ ₹ 25 per share)			

Forfeiture of Shares

The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money may result in forfeiture of shares. Forfeiture of shares is the action taken by a company to cancel the shares. The directors are usually empowered by the action taken by a company to cancel the shares. The directors are usually empowered by the Articles of Association to forfeit those shares by serving proper notice to the defaulting shareholder (s). When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him. The shareholder then has no further claim on the company. The power of forfeiture must be exercised strictly having regard to the rules and regulations provided in the Articles of Association and it should be bonafide in the interests of the company.

The Articles of a company usually authorize the Directors to forfeit shares of a member on account of non-payment of a call or interest thereon after serving him a prior notice as prescribed by the Articles. Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.

Accounting Entries

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

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

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

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

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

Forfeiture of Shares which were issued at Par

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

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

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

Share Capital Account		Dr. [No of shares x called-up value per share
To Calls-in-arrears Account		[Total amount due, but not paid]
To Forfeited Shares Account		[Amounts received]

Illustration 11

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

Solution:

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

Illustration 12

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

Solution:

	In the books of X Ltd			
Date	Journal Particulars		Dr. ₹	Cr. ₹
	Equity Share Capital A/c (200 x ₹ 8)	Dr.	1,600	
	To Calls-in-Arrears A/c (200 x ₹ 2)			400
	To Forfeited Shares A/c (200 x 6)			1,200
	(Being the forfeiture of 200 equity shares of ₹ 10 Each, ₹ 8 called-up for non-payment of first call Money @ ₹ 2 each as per Board's Resolution No …. Dated ….)			

Forfeiture of Shares which were issued at Discount

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

When shares are issued at a discount, the Discount Account is debited. Therefore, at the time of forfeiture of such share, Discount Account will be credited to cancel it.

Share Capital Account		Dr. [No. of shares x called-up value per share)
To Share Allotment Account		[If amount due, but not paid]

To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]
To Discount on Issue of Shares Account		[No. of shares x discount per share]

(Being the forfeiture of … shares for non-payment of allotment and call(s) money as per Board's Resolution No … dated …)

Illustration 13

H.P. Ltd forfeited 200 equity shares of ₹ 10 each fully called-up for non-payment of final call @ ₹ 2 per share. These shares were originally issued at a discount of 10 % Application, allotment and first call money per share @ ₹ 2, ₹ 3 ₹ 2 respectively were received in time. Give Journal Entry for the forfeiture.

Solution:

In the books of H.P Ltd - Journal				
Date	Particulars		Dr. ₹	Cr. ₹
	Equity Share Capital A/c (200 x ₹ 10)	Dr.	2,000	
	To Equity Share Final Call A/C (200 x ₹ 2)			400
	To Forfeited Shares A/c (200 x ₹ 7)			1,400
	To Discount on Issue of Shares A/c (200 x ₹ 1)			200
	(Being the forfeiture of 200 equity shares of ₹ 10 each Fully called-up for non-payment of final call money @ ₹ 2 each as per Board's resolution No … dated …)			

Forfeiture of Shares which were issued at Premium

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

If premium not received

Share Capital A/c	Dr.	[called up value]
Securities Premium A/c	Dr.	[Amount of Security premium not received]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

If premium received

Share Capital A/c	Dr.	[called up value]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

Illustration 14

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

Solution:

	In the books of X Ltd.			
Date	Particulars		Dr. ₹	Cr. ₹
	Equity Share Capital A/c (500 x ₹ 10)	Dr.	5,000	
	Securities Premium A/c (See Note)	Dr.	1,000	
	To Equity Share Allotment A/c (500 x ₹ 5)			2,500
	To Equity Share First and Final Call A/c			
	(500 x ₹ 5)			2,500
	To Forfeited Shares A/c (500 x ₹ 2)			1,000
	Each fully called-up, issued at a premium of 20%, For non-payment of allotment and call money as per Board's Resolution No .... Dated ….)			

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

Forfeiture of fully paid-up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specifically provide it.

Re-issue of Forfeited Shares

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

The Share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrears on those shares.

Accounting Entries

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

Points for consideration:

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

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

Calculation of Profit on Re-issue of Forfeited Shares

You will appreciate that the credit balance of forfeited shares account cannot be considered a surplus until the shares forfeited have been re-issued, because the company may, on re-issue, allow the discount to the new purchaser equivalent to the amount held in credit in this regard in the forfeited shares Account. Suppose 120 shares of a nominal value of ₹ 10 have been forfeited upon which ₹ 5 per share was paid up and transferred to Forfeited Share Account. Afterwards, 50 shares are re-issued, ₹ 6 per share being collected to make them fully paid up; ₹ 200 out of shares forfeited will be credited to Share Capital Account to make up the deficiency on re-issued shares, and ₹ 50 will be transferred to the capital Reserve Account being the surplus on re-issue of the 50 shares. It would have in the Forfeited shares Account balance equivalent to the amount collected on the remaining 70 forfeited shares which will be carried forward till these are re-issued.

In the above case, it has been assumed that the amount paid up on all the 120 forfeited shares was ₹ 5 per share. But in practice, shares may be forfeited on which varying amounts are out-standing. For instance, if in the above case 70 shares were forfeited with ₹ 5 paid up thereon and 50 shares with ₹ 7.50 was paid up thereon, the credit in the forfeited Shares Account would be ₹ 725. The amount to be credited to Capital Reserve will depend on the lot of shares re-issued; it will be ₹ 175 if the shares are those on which ₹ 7.50 originally paid.

Illustration 15

X Ltd. reissued 200 equity shares of ₹ 10 each @ ₹ 7 per share. These shares were issued originally at a discount of 10 %. Give Journal Entries for re-issue only.

Solution:

	In the books of X Ltd.			
Date	Journal Particulars		Dr. ₹	Cr. ₹
	Bank A/c (200 x7)	Dr.	1,400	
	Discount on Issue of Shares A/c (200 x ₹ 1)	Dr.	200	
	Forfeited Shares A/c (200 x ₹ 2)	Dr.	400	
	To Equity Share Capital A/c			2,000
	(Being the re-issue of 200 equity shares of ₹ 10 each @ ₹ 7 per share. Loss equal to original Discount is debited to Discount on Issue of Shares Account and the balance of loss is transferred To Forfeited Shares Account as per Board's Resolution No …. Dated ….)			

Illustration 16

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

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

Solution:

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

Working Note:

Calculation of amount to be transferred to Capital Reserve	
Forfeited amount per share = ₹ 5,000/200	= ₹ 25
Loss on re-issued	= ₹ 10
Surplus per share re-issued	= ₹ 15
Transferred to capital Reserve ₹ 15x 150 = ₹ 2,250 ₹ 25x50 = ₹ 1,250 should be shown as an addition to share capital.	

Illustration 17

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

Pass the necessary entries in the Journal of the company to record the forfeiture and re-issue of the share. Also prepare the Balance Sheet of the company.

Solution:

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

Balance Sheet of Beautiful Limited as at ……..

Particulars	Notes No.	₹
EQUITY AND LIABILITIES		
Shareholders' funds		
Share capital	1	29,900
Reserves and Surplus	2	6,250
Total		36,150
ASSETS		
Current assets		
Cash and cash equivalents (bank)		36,150
Total		36,150

Notes to accounts

1	Share Capital		
	Equity share capital		
	Issued share capital		
	3,000 Equity shares of ₹ 10 each	30,000	
	Subscribed, called up and paid up share capital		
	2,975 Equity shares of ₹ 10 each	29,750	
	Add: Forfeited shares	150	
2.	Reserves and Surplus		29,900
	Securities Premium	5,900	
	Capital Reserve	350	6,250

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

Amount forfeited per share of Ram ₹ 3	Amount forfeited per share of Shyam ₹ 6
Less: Loss on re-issue per share (₹ 2)	Less: Loss on re-issue per share (₹ 2)
Surplus ₹1	Surplus ₹4
Transferred to Capital Reserve: Ram share (50 x ₹ 1) ₹ 50	Shyam's Share (75 x ₹ 4) ₹ 300
Total ₹350	

Illustration 18

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

Solution:

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

Working Note:

Shareholders	Money received				Money Not Received On		
	Appli-cation	Allot-ment	First Call	Final Call	Allot-ment	First Call	Final Call
A	200	-	-	-	200	200	200
B	400	400	-	-	-	400	400

C	300	300	300	-	-	-	300
TOTAL	900	700	300	-	200	600	900
Money							
Receivable	₹ 2	₹ 3	₹ 3	₹ 2	₹ 3	₹ 3	₹ 2
	₹ 1,800	₹2,100	₹ 900	-	₹600	₹ 1,800	₹ 1,800

Illustration 19

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

Solution:

Dr	In the Books of B Ltd Cash Book (Bank column only)				Cr
Date	Particulars	₹	Date	Particulars	₹
	To Equity Share			By Equity Share	
	Application A/c	1,20,000		Application	20,000
	(Being application money Received on 24,000 shares @ ₹ 5 each)			(Being excess Money refunded on 4,000 shares @ ₹ 5 each as per Board's Resolution No … dated…)	
	To Equity Share Allotment				
	A/c	99,250		By Balance c/d	2,38,950
	(Being allotment money Received on 19,850 Shares @ ₹ 5 each)				
	To Equity Share Final Call				
	A/c	39,700			
	(Being final call money Received on 19, 850 shares @ ₹ 2 each)				
		2,58,950			2,58,950

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

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

Issue of Shares for Consideration other than Cash

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

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

Accounting Entries

(a) When assets are purchased in exchange of shares

Assets Account Dr.

To Share Capital Account

(b) When assets are issued to promoters

Goodwill Dr.

To Share Capital Account

Illustration 20

X Co. Ltd. was incorporated with an authorized share capital of 1,00,000 equity shares of ₹ 10 each. The directors decided to allot 10, 000 shares credited as fully paid to the promoters for their services.

The company also purchased land and buildings from Y Co. Ltd for ₹ 4,00,000 payable in fully paid-up shares of the company. The balance of the shares were issued to the public, which were fully subscribed and paid for.

You are required to pass Journal Entries and to prepare the Balance Sheet.

Solution:

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

Balance Sheet of X Company Limited as at …

	Particulars	Notes No.	₹
	EQUITY AND LIABILITIES		
	Share capital	1	10,00,000
	Total		10,00,000
	ASSETS		
1.	Non-current assets		
	A Fixed assets		
	i Tangible assets	2	4,00,000
	ii Intangible assets	3	1,00,000
2.	Current assets		
	Cash and equivalents	5	5,00,000
	Total		10,00,000

Notes to accounts

1		₹
	Share Capital	
	Equity share capital	
	Authorised Share capital	
	1,00,000 Equity shares of ₹ 10 each	10,00,000
	Issued share capital	
	1,00,000 Equity shares of ₹ 10 each	10,00,000
	Out of the above 50, 000 shares have been allotted as fully paid up pursuant	
	To contract (s) without payment being received in cash	
2	Tangible Assets	
	Land and Building	4,00,000
3	Intangible Assets	
	Goodwill	1,00,000
4	Cash and cash equivalents	
	Balances with banks	5,00,000

Redemption of Preference Shares

Redemption is the process of repaying an obligation, at prearranged amounts and timings. The conditions of the issue of preference shares include a call provision, i.e. a contract giving the right to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company. The redemption date is the maturity date, which specifies when repayment takes place and is usually printed on the preference share certificate. Through the process of redemption, a company can also adjust its financial structure, for example, by eliminating preference shares and replacing those with other securities if future growth of the company makes such change advantageous.

Purpose of issuing Redeemable Preference Shares

A company may issue redeemable preference shares because of the following:

1. It is a proper way of raising finance in a dull primary market.
2. A company may face difficulty in raising share capital, as its shares are not traded on the stock exchange. Potential investors, hesitant in putting money into shares that cannot easily be sold, may be encouraged to invest if the shares are redeemable by the company.
3. The preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilized in the business for profitable use.
4. A company may require additional capital in the medium term for a project, but the project is expected to generate sufficient funds to enable the preference shares to be reduced.

In India the issue and redemption of preference shares is governed by the Companies Act.

Provisions of the Act

A company limited by shares if so authorized by its Articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period not exceeding twenty years (excluding infrastructure projects) from the date of their issue. It should be noted that:

(1) No shares can be redeemed except out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;

(2) No such shares can be redeemed unless they are fully paid;

(3) The premium, if any, payable on redemption must be provided for out of the profits of the company or out of the Companies securities premium account before the shares are redeemed.

(4) Where any such shares are redeemed, otherwise than out of the proceeds of a fresh issue, there shall, out of profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption reserve Account, a sum equal to the nominal amount of the shares redeemed; and the provisions of the Act relating to the reduction of the share capital of a company shall, except as provided in the Section, apply as if the Capital Redemption Reserve (CRR) Account were the paid-up share capital of the company. The utilization of CRR Account was further restricted to issuance of fully paid-up bonus shares only to complete the picture of capitalisation.

From the legal provision outlined above, it is apparent that on the redemption of redeemable preference shares issued by a company must be redeemed within the maximum period allowed under the Act. Thus, a company cannot issue irredeemable preference shares. The Act ensures that there is no reduction in shareholders' funds due to redemption and thus the interest of outsiders is not impaired. For this, it requires that either fresh issue of shares is made or distributable profits are retained and transferred to 'Capital Redemption Reserve Account'.

The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital. The interest of outsiders is protected if the nominal value of capital redeemed is substituted, thus, ensuring the same amount of shareholders fund. In case of redemption of preference shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious. But, if redemption is done out of distributable profits, replacement of capital is ensured in an indirect manner by retention of profit by transfer to Capital Redemption Reserve. In this case, the amount which would have gone to shareholders in the form of dividend is retained in the business and is used for settling the claim of preference shareholders. Thus, there is no additional claim on net assets of the Company. The transfer of divisible profits to Capital Redemption Reserve makes them non-distributable profits. As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.

Security cover available to outside stakeholders depends upon called-up capital as well as uncalled capital to be demanded by the company as per its requirements. The Act ensures that the interests of outsiders are not reduced, and provides for redemption of only fully paid-up shares.

From the above paras, it can be concluded that the 'gap' created in the Companies capital by the redemption of redeemable preference shares much be filled in by.

(a) The proceeds of a fresh issue of shares;

(b) The capitalization of undistributed profits; or

(c) A combination of (a) and (b).

Redemption of preference shares by fresh issue of shares

One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity share or preference share) and the proceeds from such new shares can be used for redemption of preference shares.

The proceeds from issue of debentures cannot be utilized for the purpose.

A problem arises when a fresh issue is made for the purpose of redemption of preference shares, at a premium. The point to ponder is that whether the proceeds of a fresh issue of shares will include the amount of securities premium for the purpose of redemption of preference shares.

For security premium account, Companies Act provides that:

The securities premium account may be applied by the company;

(a) In paying up un-issued shares of the company to be issued to members of the company as fully paid bonus shares;

(b) In writing off the preliminary expenses of the company;

(c) In writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or

(d) In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

Any other way, except the above four prescribed ways, in which securities premium account is utilized, will be in contravention of law. It is interesting to note that clause (d) above allows premium on redemption of preference shares to be adjusted against Securities Premium account but the redemption itself cannot financed out the Securities Premium Account.

Again, a problem may arise when the fresh issue is made at a discount. Proceeds in connection with issue of shares at a discount would mean only the net amount received that is face value less the discount. Suppose a share of ₹ 100 (face value) is issued at a discount of 5% money available from the proceeds of a fresh issue is ₹ 95 and not ₹ 100. Hence, the company can redeem only ₹ 95. Therefore, the face value shares to be issued at a discount should be manipulated to ensure that at least the face value of the shares to be redeemed has been procured in money out of the proceeds of the fresh issue at a discount.

Reasons for issue of New Equity Shares

A company may prefer issue of new equity shares for the following reasons.

(a) When the company has come to realize that the capital is needed permanently and it makes more sense to issue equity Shares in place of Redeemable preference Shares which carry a fixed rate of dividend.

(b) When the balance of profit, which would otherwise be available for dividend, is insufficient.

(c) When the liquidity position of the company is not good enough.

Advantages of redemption of preference shares by issue of fresh equity shares

Following are the advantages of redemption of preference shares by the issue of fresh equity shares:

(1) No cash outflow of money – now or later.

(2) New equity shares may be valued at a premium.

(3) No capital gains tax for shareholders

(4) Shareholders retain their equity interest.

Disadvantage of redemption of preference shares by issue of fresh equity shares

The disadvantages are:

(1) There is a possibility of dilution of further earnings.

(2) Share holdings in the company are changed.

Accounting Entries

1. When new shares are issued at par Dr.

Bank Account

To Share Capital Account

(Being the issue of ……..shares of ₹ ……… each for the Purpose of redemption of preference shares, as per Board's Resolution No……. dated…….)

2. When new shares are issued at a premium

Bank Account Dr.

To Share Capital account

To Securities premium account

(Being the issue of ……….. shares of ₹ ……. Each a premium of ₹… each for the purpose or redemption of preference shares as per board 's Resolution No …… dated……..)

3. When new shares are issued at a discount

Bank Account Dr.

Discount on issue of shares Account Dr.

To Share Capital Account

(Being the issue of …… shares of ₹ …. Each at a discount of ₹…. each for the purpose of redemption of preference shares, as per Board's Resolution No … dated…)

4. When preference shares are redeemed at par

Redeemable preference share Capital Account Dr.

To preference Shareholders Account

5. When preference shares are redeemed at a premium

Redeemable preference Share Capital Account Dr.

Premium on Redemption of preference Shares Account Dr.

To preference Shareholders Account

6. When payment is made to preference shareholders

Preference shareholders Account Dr.

To Bank Account

7. For adjustment of premium on redemption

Profit and Loss Account Dr.

Securities premium Account Dr.

To premium on Redemption of Preference Shares Account

Illustration 1

Hinduja Company Ltd. Had 5,000 8% Redeemable preference Shares of ₹ 100 each, fully paid up. The Company decided to redeem these preference shares by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at par. You are required to pass necessary journal Entries including cash transactions in the books of the company.

Solution:

	In the books of Hinduja Company Ltd. Journal Entries		
Date	Particulars	Dr (₹)	Cr.(₹)
	Bank A/c To Equity Share capital A/c (being the issue of 50,000 Equity shares of ₹ 10 each at par of the purpose of redemption of preference shares, As per Board Resolution No... Dated…)	5,00,000	5,00,000
	8% Redeemable preference share capital A/c To preference shareholder A/c (Being the amount payable on redemption of preference shares transferred to preference Shareholders Account)	5,00,000	5,00,000
	Preference shareholders A/c to Bank A/c (Being the amount paid on redemption of preference shares)	5,00,000	5,00,000

Illustration 2

C Ltd. had 10,000 10 % redeemable preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2per share as fully paid up. You are required to pass necessary journal Entries including cash transactions in the books of the company.

Solutions:

In the books of c Ltd. - Journal Entries			
Date	Particulars	Dr.(₹)	Cr. (₹)
	Bank A/c Dr. To Equity share Capital A/c To Securities Premium A/c (Being the issue of 1,00,000 Equity shares of ₹ 10 Each at a premium of ₹ 2 per share as per Board's Resolutions No… dated….)	12,00,000	10,00,000 2,00,000
	10% Redeemable preference Share Capital A/c Dr. To preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to preference shareholders A/c)	10,00,000	10,00,0000

	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	10,00,000	10,00,00000

Note: Amount required for redemption is ₹ 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to ₹ 10,00,000 premium received on new issue cannot be used to finance the redemption.

Illustration 3

G India Ltd. Had 9,000 10% redeemable preference shares of ₹ 10 each, fully paid up. The company decided to redeem these preference shares at pat by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at a discount of 10% You are required to pass necessary journal Entries including cash transactions in the books of the company.

Solution:

In the books of G India Limited - Journal			
Date	Particulars	Dr. (₹)	Cr. ₹
	Discount on issue of shares A/c Dr. To Equity share capital A/c (Being the issue of 10,000 Equity shares of ₹ 10 each at a discount of 10 % as per Board's Resolutions no…. Dated...)	90,000 10,000	1,00,000
	10% Redeemable preference shares capital A/c Dr. To preference shareholders A/c (Being the amount payable on redemption of preference shares transferred to preference shareholders A/c)	90,000	90,000
	Preference shareholders A/c Dr. To Bank A/c (Being the amount paid on redemption of preference shares)	90,000	90.000

Note: When shares are redeemed by issuing shares at a discount, the proceeds from new issue must be sufficient to cover the face value of shares redeemed.

Here, face value of shares to be redeemed is ₹ 90,000 proceeds from each new share are ₹ 9 (₹ 10-10*10% discount). Therefore the number of new shares to be issued =₹ 90, 000/₹ 9=10,000 shares.

Calculation of Minimum Fresh issue of Shares

Sometimes, examination problem does not specify the number of shares to be issued for the purpose of redemption of preference shares and requires that the minimum number of shares should be issued to ensure that provisions of the Act are not violated, this is done in four steps as given below:

(1) In such cases, the maximum amount of reserves and surplus available for redemption is ascertained taking into account the balances appearing in the balance sheet before redemption and the additional information provided in the problem. for example, if balance of general reserve in the balance sheet is ₹ 1,00,000 and additional information provides that the Board of Directors have decided that the balance of general reserve should not less than ₹ 40,000 under any circumstances, then, the maximum amount of general reserve available for redemption is ₹ 60,000

(2) After ascertaining the maximum amount of reserve and surplus available for redemption, adjustment for premium on redemption payable out of profits is made and then it is compared with the nominal value of shares to be redeemed by comparison, one gets the minimum proceeds of fresh issue as the Act permits redemption either out of proceeds of fresh issue or out of divisible profits. Thus,

Minimum proceeds of fresh issue of shares:

(3) After computation of much proceeds, the minimum number of shares to be issued are determined by dividing minimum proceed by the proceeds of one share. This is done as follows:

$$\text{Minimum Number of Shares} = \frac{\text{Minimum proceeds to comply with the Act}}{\text{Proceeds of one share}}$$

Proceeds of one share mean the par value of a share issued, if it is issued at par or premium. However, in case of issue of share at a discount, it refers to the discounted value.

(4) Minimum number of shares calculated as per (3) above, needs to be adjusted due to various reasons, Firstly, shares fractions cannot be issued . Thus if minimum number of shares as per (3) above includes a fraction, it must be approximated to the next higher figure to ensure that provisions of Section 55 of Companies Act 2013 are not violated. Secondly, if the examination problem states that the proceeds/ number of shares should be a multiple of say, 10 or 50 or 100, then again the next higher multiple should be considered.

Illustration 4

The Board of Directors of a Company decide to issue minimum number of equity shares of ₹ 10 each at 10 % discount to redeem ₹ 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is ₹ 3, 00,000. Calculate the number of shares to be issued by the company to ensure that provisions of Sections 55 are not violated. Also determine the number of shares of the company decides to issue shares in multiples of ₹ 50 only.

Solutions:

Nominal value of preference shares	₹ 5, 00,000
Maximum possible redemption out of profits	₹ 3, 00,000
Minimum proceeds of fresh issue ₹ 5, 00,000-3, 00,000	= ₹ 2, 00,000
Proceed of one shares = Nominal value-Discount= 10-1	= ₹ 9
Minimum number of shares = 2, 00,000/9	= 22, 222, 22 shares
As fractional shares are not permitted, the minimum of shares to be issued is 22,223 shares if shares are to be issued in multiples number of 50, then the next higher figure which is a multiple of 50 is 22,250. Hence minimum number of shares	

Illustration 5

The Balance sheet of a company on 30 .6.2012 is as follow:

Particulars	₹
EQUITY AND LIABILITIES	
1. Shareholders' funds	
a. Share capital	7,00,000
b. Reserve and surplus	1,00,000
2. Current liabilities	2,00,000
Total	10,00,000
ASSETS	
1. Fixed Assets	
Tangible asset	6,00,000
2. Current Asset	
Cash and cash equivalents (bank)	4,00,000
Total	10,00,000

The share capital of the company consists of ₹ 10 each equity shares of ₹ 5,00,000 and ₹ 100 each preference shares of ₹ 2,00,000. Reserve and surplus comprise securities premium of ₹ 10, 000 and profit and Loss Account ₹ 90,000.

Compute the minimum number of equity shares of ₹ 10 each that the company must issue at par to redeem preference shares at a premium of 10%

Solution:

Nominal value of preference shares ₹ 2,00,000	
Premium on redemption 10% of ₹ 2,00,000	₹ 20,000
Securities premium	= ₹ 10,000
Premium of redemption payable out of profits 2,0000-10,000	= ₹ 10,000
Profits available for redemption 90,000-10,000	= ₹ 80,000
Minimum proceeds 2,00,000-80,000	= ₹ 1,20,000
Minimum number of shares	= 12,000 shares

Fresh issue at a premium and Minimum, fresh issue

The calculation of minimum number of shares, when issue is at a premium should be handled very carefully because premium of fresh issue of shares is available for writing off premium on redemption also. Minimum fresh issue can not be calculated unless one know the profits available for replacement of capital and profit available for replacement cannot be determined unless one knows the portion of profit available for redemption is not required for paying premium on redemption of preference shares. In other words, it means that securities premium including premium on fresh issue is comparatively more than premium on redemption.

If the above assumption holds goods, minimum number of shares can be calculated in a simple manner without use of equation. But, if above conditions are not met, then an equation is used to determine the minimum number of shares.

Minimum fresh issue to provide funds for Redemption

Besides, ensuring compliance with Section 55 the fresh issue of shares is made to provide funds for making payment to preference shareholders, to calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by the fresh issue of shares are calculated. The amount to be raised is divided by the issue price of a share (amount payable by shareholder including premium, if any, on fresh issue) to compute the minimum number of shares to be issued.

Illustration 6

The balance sheet of x Ltd. As on 31st March, 2012 is as follows	
Particulars	₹
EQUITY AND LIABILITIES	
1. Shareholders' funds	
a. Share capital	2,90,000

b. Reserves and surplus	48,000
2. Current liabilities	
Trade payable	56,000
TOTAL	3,94,500
ASSETS	-
1. Fixed Assets	
Tangible asset	3,45,000
Noncurrent investment	18,500
2. Current Assets	
Cash and cash equivalents (bank)	31,000
TOTAL	3,94,500

The share capital of the company consists of ₹ 50 each equity shares of ₹ 2, 25,000 and ₹ 100 each preference shares of ₹ 65,000 reserves and surplus comprises profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10% the company decided:

(a) To sell all the investment for ₹ 15,000.

(b) To finance part of redemption from company funds, subject to, leaving a bank balance of ₹ 12,000

(c) To issue minimum equity share of ₹ 50 each at a premium of ₹ 10 per share to raise the balance of funds required

You are required to pass the necessary Journal Entries to record the above transactions and prepare the balance sheet as on completion of the above transactions.

Solutions:

X Ltd - Journal			
Bank A/c	Dr.	37,500	
To share Applications A/c			37,500
(for applications money received on 625 shares @ ₹ 60 per share)			
Share Applications A/c	Dr.	37,500	
To Equity share capital A/c			31,250

To Securities premium A/c			6,250
(for dispositions of applications money received)			
Preference Share Capital A/c	Dr.	65,000	
Premium on Redemption of			
Preference Shares A/c	Dr.	6,500	
To Preference Shareholders A/c			71,500
(for amount payable on redemption of preference shares)			
Securities Premium A/c	Dr.	6,250	
Profit and Loss A/c	Dr.	250	
To premium on redemption of			
Preference Shares A/c			6,500
(For writing off premium on redemption firstly out of securities premium and balance out of profits)			
Bank A/c	Dr.	15,000	
Profit and Loss A/c (loss on sale) A/c	Dr.	3,500	
To Investment A/c			18,500
(For sale of investments at a loss of ₹ 3,500)			
Profit and Loss A/c	Dr	33,750	
To Capital Redemption Reserve A/c			33,750
(For transfer to CRR out of divisible profits an amount equivalent to excess of nominal value over proceeds i.e., ₹ 65,00-₹ 31,250)			
Preference Shareholders A/c			
To Bank A/c	Dr.	71,500	71,500
(For payment of preference shareholders)			
Capital Redemption Reserve A/c			
To Bonus to shareholders A/c	Dr.	25,000	25,000
(For making provision for issue of 500 bonus shares)			
Bonus to Shareholders A/c			
To Equity Share Capital a/c	Dr.	25,000	25,000
(For issue of bonus shares)			

Balance Sheet (after redemption)		
Particulars	Notes No.	₹
EQUITY AND LIABIITIES		
1. Shareholders' funds		
a. Share capital	1	2,56,250
b. Reserves and surplus	2	44,250
2. Current liabilities		
Trade payables		56,500
Total		3,57,000
Assets		
1. Fixed assets		
Tangible asset		3,45,000
2. Current Assets		
Cash and cash equivalents	3	12,000
Total		3,57,000

Notes to Accounts

		₹
1	Share Capital	
	Equity share capital	2,56,250
2	Reserve share surplus	
	Capital Redemption Reserve	33,750
	Profit and Loss Account (48,000-250-3,500-33,750)	10,500
		44,250
3	Cash and cash equivalents	
	Balance with banks (31,000+37,500+15,000-71,500)	12,000

Working note:

Calculation of Number of Shares:	₹
Amount payable on redemption	71,500
Less: sale price of investment	-15,000
	56,500
Less: Available bank balance (31,000-12,000)	-19,000
Funds from fresh issue	37,500
No. of shares =37,500/60=625 shares	

Redemption of Preference Shares by Capitalisation of undistributed profits

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares. When shares are redeemed by utilizing distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit. In other works, some of the distributable profits are kept aside to ensure that it can never be distributed to shareholders as dividend.

In this connection, the provisions of the Companies Act state that 'When any such are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend, be transferred to a reserve fund to be called the Capital Redemption Reserve Account sum equal to the nominal amount of the shares redeemed.

Advantages of redemption of preference shares by capitalization of undistributed profits

The advantages of redemption of preference shares by capitalization of undistributed profits are:

No change in the percentage share holdings of the company;

Future earnings are not diluted;

Surplus funds can be used.

Disadvantages of redemption of preference shares by capitalization of undistributed profits

The disadvantages of redemption of preference shares by capitalization of undistributed profits are:

There may be a reduction in liquidity;

Capital gains tax liability for preference shareholders

Accounting Entries

1. When shares are redeemed at par	
Redeemable Preference Share Capital Account	Dr.
To preference shareholders Account	
(Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)	

2. When shares are redeemed at a premium	
Redeemable Preference Share Capital Account	Dr.
Premium on redemption of preference shares Account	Dr.
To Preference Shareholders Account	
(Being the amount payable on redemption transferred to Preference Shareholders Account)	
3. When payment is made to preference shareholders	
Preference shareholders Account	Dr.
To Bank Account	
(Being the amount payment to preference shareholders as per terms)	
4. For adjustment of premium of redemption	
Profit and Loss Account	Dr.
Securities Premium Account	Dr.
To premium on redemption of preference shares Account	
(Being the premium on redemption adjusted against Profit and Loss account and Securities Premium Account)	
5. For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account)	
General Reserve Account	Dr.
Profit and Loss Account	Dr.
To Capital redemption Reserve Account	
(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).	

Illustration 7

The following are the extracts from the Balance Sheet of ABC Ltd. As on 31st December, 2010. Share capital: 40.000 equity shares of ₹ 10 each fully paid –₹ 4,00,000; 1,000 10% redeemable preference shares of ₹ 100 each fully paid-₹ 1,00,000.

Reserve & Surplus: Capital reserve-₹ 50,000; securities premium – ₹ 50,000; General reserve- ₹ 75,000; Profit and Loss Account-₹ 35,000

On 1st January 2011, the Board of Directors decided to redeem the preference shares par by utilization of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution:

In the books of ABC Limited - Journal Entries				
Date 2011	Particulars		Dr. (₹)	Cr. (₹)
Jan 1	10% Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption transferred to Preference Shareholders Account)	Dr	1,00,000	 1,00,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr	1,00,000	 1,00,000
	General Reserve A/c Profit & Loss A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the Requirement of the Act)	Dr Dr	75,000 25,000	 1,00,000

Note: securities premium cannot be utilized for transfer to Capital Redemption Reserve because dividend cannot be paid out of securities premium Account.

Redemption of preference shares by combination of fresh issue and capitalisation of undistributed profits

A Company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer to be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.

Formula:	
(i) Amount to be Transferred to Capital Redemption Reserve	₹
Face value of shares redeemed	xxx
Less: Proceeds from new issue	xxx
	xxx
(ii) Proceeds to be collected from New Issue	₹
Face value of shares redeemed	xxx
Less: Profits available for distribution as dividend	xxx
	xxx

Illustration 8

C Limited had 3,000, 12% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

(i) 25,000 Equity Shares of ₹ 10 each at par,

(ii) 1,000 14% Debentures of ₹ 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

Solution:

	In the books of C limited Journal Entries			
Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being the issue of 25,000 equity shares of ₹ 10 each at par as per Board's resolution No…..dated….)			
	Bank A/c	Dr.	1,00,000	
	To 14% Debenture A/c			1,00,000
	(Being the issue of 1,000 Debentures of ₹ 100 each as per Board's Resolution No …….. dated…….)			
	12% Redeemable Preference Share Capital A/c	Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	30,000	
	To Preference Shareholders A/c			3,30,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			

	Preference Shareholders A/c	Dr.	3,30,000	
	To Bank A/c			3,30,000
	(Being the amount paid on redemption of preference shares)			
	Profit & Loss A/c	Dr.	30,000	
	To Premium on Redemption of Preference Shares A/c (Being the adjustment of premium on redemption against Profits & Loss Account)			30,000
	Profit & Loss A/c		50,000	50,000
	To Capital Redemption Reserve A/c(Note 1) (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	Dr.		

Working Note:

Amount to be transferred to Capital Redemption Reserve Account	
Face Value of shares to be redeemed	3,00,000
Less: Proceeds from new issue	2,50,000
Total Balance	50,000

Illustration 9

The capital structure of a company consists of 20,000 Equity Shares of ₹ 10 each fully paid up and 1,000, 8% Redeemable Preference Shares of ₹100 Each fully paid up.

Undistributed reserve and surplus stood as: General Reserve ₹ 80,000; Profit and Loss Account ₹ 10,000; Investment Allowance Reserve out of which ₹ 5,000, (not free for distribution as dividend) ₹ 10,000; Securities Premium of ₹ 12000. Premium payable on redemption is 10% and for the purpose of redemption, the directors are empowered to make fresh issue of equity shares at par after utilizing the undistributed reserve and surplus, subject to the conditions that a sum of ₹ 20,000 shall be retained in general reserve and which should not be utilized. Pass Journal Entries to give effect to the above arrangements and also show how the relevant items will appear in the Balance Sheet of the company after the redemption carried out.

Solution:

	In the books of …..Journal Entries			
Date	Particulars		Dr. (₹)	Cr. ₹)
	Bank A/c To Equity Share Capital A/c (Being the issue of 2,500 Equity Shares of ₹ 10 each at a premium of Re. 1 per share as per Board's Resolution ...No..Dt.)	Dr.	25,000	 25,000
	8% Redeemable Preference Share Capital A/c Premium in Redemption of Preference Shares A/c To Preference Shareholders a/c (Being the amount paid on redemption transferred to Preference Shareholders Account) Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr. Dr. Dr.	1,00,000 10,000 1,10,000	 1,10,000 1,10,000
	Securities Premium A/c To Premium on Redemption of Preference Shares A/c (Being the premium payable in redemption provided out of securities Premium Account)	Dr.	10,000	 10,000
	General Reserve A/c Profit & Loss A/c Investment Allowance Reserve A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital redemption Reserve Account as per the requirement of the Act	Dr. Dr. Dr.	60,000 10,000 5,000	 75,000

Balance Sheet as on …..[Extracts]

	Particulars	Notes No.	₹
	EQUITY AND LIABILITIES		
	Shareholders' funds a. Share Capital b. Reserves and Surplus	 1 2	 2,25,000 1,02,000
	Total		?

	ASSETS Current Assets Cash and cash equivalents		 13,000
	Total		?
Notes to Accounts			
	Shares Capital		
	22,500 Equity shares of ₹ 10 each fully paid up		2,25,000
	Reserves and Surplus		
	General Reserve Securities Premium (₹ 12,000-₹10,000) Capital Redemption Reserve Investment Allowance Reserve		20,000 2,000 75,000 5,000
			1,02,000

Working Note:

No of Shares to be issued for redemption of Preference Share;		
Face value of Shares redeemed		1, 00,000
Less: Profit available for distribution as dividend:		
General Reserve: ₹ (80,000-20,000)	60,000	
Profit and Loss	10,000	
Investment Allowance Reserve (₹ 10,000-5,000)	5,000	
		75,000
Therefore, No. of shares to be issued = 25,000/₹ 10=2,500 shares.		25,000

Illustration 10

The books of B Ltd. showed the following balance on 31st December, 2010: 30,000 Equity Shares of ₹ 10 each fully paid; 18,000 12% Redeemable Preference Shares of ₹ 10 each fully paid; 4,000 10% Redeemable Preference Shares of ₹ 10 each, ₹ 8 Paid up.

Undistributed Reserve and Surplus stood as: Profit and Loss Account ₹ 80,000; General Reserve ₹ 1, 20,000; Securities Premium Account ₹ 15,000 and Capital Reserve ₹ 21,000.

Preference shares are redeemed on 1st January, 2011 at a premium of ₹ 2 Per share. The whereabouts of the holders of 100 shares of ₹ 10 each fully paid are not known.

For redemption, 3,000 equity shares of ₹ 10 each are issued at 10% premium. At the same time, a bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital redemption Reserve Account.

Show the necessary journal Entries to record the transactions.

Solution:

	In the books of B limited Journal Entries			
Date	Particulars		Dr. (₹)	Cr.(₹)
2011 Jan 1	12% Redeemable Preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (Being the amount payable on redemption of 18,000 12% Redeemable Preference Share transferred to Shareholders Account)	Dr. Dr.	1,80,000 36,000	 2,16,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of 17,900 preference shares) Bank A/c To Equity Shares Capital A/c To Securities Premium A/c (Being the issue of 3,000 Equity Share of ₹ 10 each at a premium of 10% as per Board's Resolution No…..Dated….)	Dr. Dr.	2,14,800 33,000	 2,14,800 30,000 3,000
	General Reserve A/c Profit & Loss A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital redemption Reserve A/c as per the requirement of the Act.)	Dr. Dr.	1,20,000 30,000	 1,50,000
	Capital Redemption Reserve A/c To bonus to Shareholder A/c (Being the amount appropriate for issue of bonus share in the ratio of 5:2 as per shareholders Resolution No…..dated…….)	Dr.	1,20,000	 1,20,000

	Bonus to Shareholders A/c To Equity Share Capital A/c (Being the utilization of bonus dividend for issue of 12,000 equity shares of ₹ 10 each fully paid)	Dr.	1,20,000	1,20,000
	Securities Premium A/c Profit & Loss A/c To Premium on Redemption of Preference Shares A/c	Dr. Dr.	18,000 18,000	36,000

(Being premium on redemption of preference shares adjusted against Securities Premium Account and the balance charged to Profit & Loss Account)

Working Note:

(1) Partly paid-up preference shares cannot be redeemed.	
(2) Amount to be Transferred to Capital Redemption Reserve Account	
Face value of share to be redeemed	1,80,000
Less: Proceeds from fresh issue (excluding Premium)	30,000
	1,50,000

Sale of Investments to provide sufficient funds for Redemption

Companies may have sufficient investments, which can be sold, in the market to arrange fund for redemption preference shares'

Redemption of Partly Called-up Preference Shares

One of the conditions of redemption is that only fully paid up preference shares can be redeemed by a company. If the examination problem states that it is decided to redeem preference shares which are partly called up, then it is assumed that final call on these shares is demanded and received before proceeding with redemption of these shares. If information about both fully paid and partly paid preference shares if provided, then, only fully paid shares are redeemed.

Illustration 11

The balance sheet of XYZ as at 31st December, 2010 inter alia includes the following:

50,000, 8% Preference Shares of ₹ 100 each, ₹ 70 paid up	35,00,000
1,00,000 Equity Shares of ₹ 100 each fully paid up	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 2011 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹ 100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) made on 1st March, 2011. The money due on allotment was received by 31st March, 2011. The preference shares were redeemed after fulfilling the necessary conditions of the Companies Act. The company decided to make minimum utilization of general reserve.

You are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2011 with the corresponding figures as on 31st December, 2010.

Solution:

	XYZ company - Journal entry			
	8% Preference Share Final Call A/c To 8% Preference Share Capital A/c (For final call made on preference share @ ₹ 30 each of make them fully paid up)	Dr.	15,00,000	 15,00,000
	Bank A/c To 8% Preference Share Final Call A/c (For receipt of final call money on preference share)	Dr.	15,00,000	 15,00,000
	Bank A/c To equity Share Application A/c (for receipt of application money on 50,000 equity shares @ ₹ 20 per share)	Dr.	10,00,000	 10,00,000
	Equity Share Application A/c To Equity Share Capital A/c (For capitalization of application money received)	Dr.	10,00,000	 10,00,000
	Equity Share Allotment A/c To Equity Share Capital A/c To securities Premium A/c (For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)	Dr.	17,50,000	 12,50,000 5,00,000
	Bank A/c To Equity Share Allotment A/c (For receipt of allotment money on equity shares)	Dr.	17,50,000	 17,50,000

	8% Preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference shareholder A/c (For amount payable to preference shareholders on redemption at 5% premium)	Dr. Dr.	50,00,000 2,50,000	52,50,000
	Securities Premium A/c To premium on Redemption A/c (for writing off premium on redemption of preference shares)	Dr.	2,50,000	2,50,000
	General Reserve A/c To Capital Redemption Reserve A/c (For transfer or CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 50,00,000-10,00,000-12,50,000)	Dr.	27,50,000	27,50,000
	Preference Shareholders A/c To bank A/c (For amount paid to preference shareholders)	Dr.	52,50,000	52,50,000

Balance Sheet (extracts)

	Particulars	Notes No.	As at 31.3.2012	As at 31.3.2011
	EQUITY AND LIABILITIES			
	Shareholders' funds			
	a. Share capital b. Reserves and surplus	1 2	1,22,50,000 77,50,000	1,35,00,000 75,00,000

Notes to accounts

			As at 31.3.2012	As at 31.3.2011
	Share Capital Issued, Subscribed and Paid up: 1,00,000 Equity shares of ₹ 100 each fully paid up 50,000 Equity shares of ₹ 100 each ₹45 paid up 50,000 8% Preference shares of ₹ 100 each, ₹ 70 called up		1,00,00.000 22,50,000 -	 1,00,00,000 - 35,00,000
			1,22,50,000	1,35,00,000

	Reserves and Surplus			
	Capital Redemption Reserve		47,50,000	20,00,000
	Securities Premium		7,50,000	5,00,000
	General Reserve		22,50,000	50,00,000
			77,50,000	75,00,000

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares are ₹ 22, 50, 00 (₹ 10, 00,000 application money plus ₹ 12,50,000 received on allotment towards share capital).

Redemption of Fully Called but Partly Paid-up Preference Shares

The problem of unpaid calls on fully called up shares may be studied under following categories:

When calls-in arrears is received by the company

If the amount of unpaid calls is received by the Company before redemption, then entry passed is as under:

Bank A/c

To Calls-in-Arrears A/c

After receipt of calls in arrears, the shares become fully paid up and, then, company can proceed with redemption in the normal course.

In case of forfeited shares

If, on getting a proper notice from the company, the shareholders fail to pay the unpaid calls, the Board of Directors may decide to forfeit the shares and cancel these shares instead of reissuing the forfeited shares because redemption of these shares is due immediately or in near future. In this case, entry for forfeiture is passed as usual.

It is worth noting that to ensure replacement of capital out of proceeds of a fresh issue or out of divisible profits, total preference share capital (including the shares forfeited and cancelled) should be considered. However, while arranging funds for redemption, amount actually payable to shareholders is taken into consideration.

Illustration 12

A company invited application for issue of 10,000 14% Redeemable preference shares of ₹ 100 each at 10% discount. The amount was payable in three equal installments. Applications were received for 16,000 shares. Incomplete applications for 1,000 shares were rejected and the remaining applicants were allocated shared on prorate basis.

Mr. X, to whom 100 shares were allotted, failed to pay the allotment and call money. Another shareholder Mr. Y, who had applied for 300 shares, failed to pay the call money.

Before redemption of preference shares, both Mr. X and Y were issued reminders to pay the unpaid amount. On getting the reminder, Mr. X paid the amount in arrear but Mr. Y failed to pay the arrears. On Mr. Y's failure to pay the arrears his shares were forfeited and cancelled Remaining preference shares were redeemed at premium of 5%. On the date of redemption, following balances appeared in the books of the Company:

Securities Premium	1,40,000
General Reserve	3,50,000
Share Discount	1,00,000

For the purpose of redemption, it was decided to issue minimum number of equity shares of ₹ 10 each at ₹ 9 per share. Shares were issued in multiples of 100. Fresh issue of share was fully subscribed and preference shares were redeemed. Transfer to C.R.R.A/c is made for redeemed shares only and not for shares cancelled.

Pass Journal Entries to record the above transactions.

Solution:

	Journal Entries		Dr. (₹)	Cr. (₹)
	Bank A/c To Share Application A/c (For application money received)	Dr.	4,80.000	 4,80,000
	Share Application A/c To 14% R. Preference Share Capital A/c To Share Allotment A/c To Bank A/c (for disposition of application money received)	Dr.	4,80.000	 3,00,000 1,50,000 30,000
	Share allotment A/c Share Discount A/c To 14% R. Preference Share Capital A/c (For amount money due)	Dr. Dr.	3,00,000 1,00,000	 4,00,000
	Bank A/c (3,00,000-1,50,000-1,500) To Share Allotment A/c (For call money due)	Dr.	1,48,500	 1,48,5000
	Share First and Final Call A/c To 14% R. Preference Share Capital A/c (For call money due)	Dr.	3,00,000	 3,00,000

	Bank A/c Call-in-Arrears A/c To Shares First and Final Call A/c (For call money Received and the amount not paid by shareholders)	Dr. Dr.	2,91,000 9,000	 3,00,000
	Bank A/c To share Allotment A/c To Calls-in-Arrears A/c (For arrears received on issue of a reminder)	Dr.	4,500	 1,500 3,000
	14% R. Preference Share Capital A/c To Share Forfeited A/c To Calls-on-Arrears A/c To Shares Discount A/c (for forfeiture of shares due on non-payment of arrears)	Dr.	20,000	 12,000 6,000 2,000
	Shares forfeited A/c To Capital Reserve A/c (For transfer of amount forfeited to capital reserve on cancellation of shares of redemption	Dr.	12,000	 12,000
	Bank A/c To share Application A/c (For application money receive don 70,000 shares @ ₹ 9 per share)	Dr.	6,30,000	 6,30,000
	Share application A/c Share Discount A/c To Equity Share Capital A/c (For disposition of application money received and recording of share discount)	Dr.	6,30,000 70,000	 7,00,000
	Securities Premium a/c To Share Discount A/c (For writing off discount on issue of preference shares before their redemption)	Dr.	1,00,000	 1,00,000
	14% R. preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (for writing off premium payable on redemption of preference shares)	Dr. Dr.	9,80,000 49,000	 10,29,000

	General Reserve A/c To Capital Redemption Reserve A/c (For transfer to CRR out of divisible profits amount equipment to the excess of nominal value of shares redeemed over he provides of fresh issue of shares i.e., 9, 80,000-6, 30,000).	Dr.	3,50,000	 3,50,000
	Preference shareholders A/c To bank A/c (for making payment to preference shareholders)	Dr.	10,29,000	10,29,000
	Securities Premium a/c Capital Reserve A/c To Premium on redemption of preference shares (For adjustment of premium on redemption of preference shares)	Dr. Dr.	40,000 9,000	 49,000

Working Note:

Calculate of Minimum Number of shares:	₹
Nominal value of Preference Shares Capital	9,80,000
Less: Divisible profits	3,50,000
Minimum Proceeds	6,30,000
Proceed of one shares =10-10%of ₹ 10=₹ 9 Number of shares = 6,30,000/9=70,000 (Approx.) Number of shares in next multiple of 100=70,000 shares.	
Capital reserve realized in cash is available for paying premium on redemption of debentures. Therefore, out of ₹ 12,000 capital reserve on cancellation of shares forfeited ₹ 9,000 is utilized for writing off premium on redemption of preference shares.	

SELF EXAMINATION QUESTIONS

1. The excess price received over the par value of shares, should be credited to _________.
   (a) Calls-in-advance account (b) Share capital account
   (c) Reserve capital account (d) Securities premium account
2. Which of the following statements is false?
   (a) The forfeited shares should not be issued at a premium
   (b) At the time of forfeiture of shares, securities premium should not be debited with the amount of premium already received.
   (c) Shares can be issued at a discount only after one year from the commencement of business
   (d) Securities premium account cannot be utilized to redeem preference shares
3. When shares are issued to promoters for the services offered by them, the account that will be debited with the nominal value of shares is _________.
   (a) Preliminary expenses account (b) Goodwill account
   (c) Asset account (d) Share capital account
4. The directors of E Ltd. made the final call of ₹ 30 per share on May 15, 2011 indicating the last date of payment of call money to be May 31, 2011. Mr.F, holding 5,000 shares paid the call money on July 15, 2011.

   If the company adopts Table F, the amount of interest on calls-in-arrear to be paid by Mr. F =?

   (a) ₹ 625.00 (b) ₹ 937.50 (c) ₹ 750.00 (d) ₹ 125.00 (e) 1875.00

   Use the following information for question 5 to 9

   B Ltd. was registered with a share capital of ₹ 1,00,00,000 divided into equity shares of ₹ 10 each. It issued 9,00,000 equity shares to the general public at par payable as to ₹ 3 on application, ₹ 3 on allotment and balance in 2 equal calls. The public had subscribed for 8,50,000 shares. Till 31st March, 2011, only first call had been made. All the shareholders had paid up except Mr. C, a holder of 25,000 shares, who did not pay the call money.
5. How much is B Ltd.'s authorized share capital?
   (a) ₹ 1,00,00,000 (b) ₹ 90,00,000
   (c) ₹ 85,00,000 (d) ₹ 68,00,000
6. How much is B Ltd.'s issued capital?
   (a) ₹ 1,00,00,000 (b) ₹ 90,00,000
   (c) ₹ 85,00,000 (d) ₹ 68,00,000

7. How much is B Ltd.'s subscribed capital?

   (a) ₹ 1,00,00,000 (b) ₹ 90,00,000

   (c) ₹ 85,00,000 (d) ₹ 68,00,000

8. How much is B Ltd.'s called up capital?

   (a) ₹ 1,00,00,000 (b) ₹ 90,00,000

   (c) ₹ 85,00,000 (d) ₹ 68,00,000

9. How much is B Ltd.'s paid up capital?

   (a) ₹ 1,00,00,000 (b) ₹ 90,00,000

   (c) ₹ 85,00,000 (d) ₹ 67,50,000

Use the following information for question 10 to 23

D Ltd. issued 2,00,000 shares of ₹ 100 each at a premium of ₹ 20 per share payable as follows:

On application	₹ 20
On allotment	₹ 50 (including premium)
On first call	₹ 30
On second and final call	₹ 20

Application were received for 3,00,000 shares and pro rata allotment was made to applicants of 2,40,000 shares. Money excess on application of 2,40,000 shares was employed on account of sum due on allotment as part of share capital. E, to whom 4,000 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited and F, the holder of 6,000 shares failed to pay the two calls and his shares were forfeited after the second call. Of the forfeited shares, 8,000 shares were reissued to G at a discount of 10% , the whole of E's forfeited shares being reissued.

10. Amount received on application = _______________.

    (a) ₹ 40,00,000 (b) ₹ 60,00,000

    (c) ₹ 48,00,000 (d) ₹ 2,40,00,000

11. Application money adjusted against allotment =____________.

    (a) ₹ 20,00,000 (b) ₹ 16,00,000

    (c) ₹ 12,00,000 (d) ₹ 8,00,000

12. Amount refunded to shareholder = ____________.

    (a) ₹ 20,00,000 (b) ₹ 16,00,000

    (c) ₹ 12,00,000 (d) ₹ 8,00,000

13. Total amount paid by E = ____________.

    (a) ₹ 80,000 (b) ₹ 10,00,000

    (c) ₹ 1,44,000 (d) ₹ 96,000

14. Total amount paid by G = ______________.

    (a) ₹ 80,000 (b) ₹ 3,00,000

    (c) ₹ 4,20,000 (d) ₹ 1,44,000

15. Total amount paid by G = ________________.

    (a) ₹ 7,20,000 (b) ₹ 8,00,000

    (c) ₹ 8,80,000 (d) ₹ 8,64,000

16. Amount transferred to Share forfeiture account at the time of forfeiting E's shares

    (a) ₹ 80,000 (b) ₹ 1,00,000

    (c) ₹ 3,00,000 (d) ₹ 96,000

17. Amount transferred to Share forfeiture account at the time of forfeiting F's shares

    (a) ₹ 80,000 (b) ₹ 3,00,000

    (c) ₹ 4,20,000 (d) ₹ 1,44,000

18. Net balance in Securities Premium Account =____________.

    (a) ₹ 2,00,00,000 (b) ₹ 2,08,00,000

    (c) ₹ 2,04,00,000 (d) ₹ 1,98,00,000

19. Net balance in Securities Premium Account = _________.

    (a) ₹ 39,20,000 (b) ₹ 39,28,000

    (c) ₹ 39,36,000 (d) ₹ 39,44,000

20. Net balance in Share Forfeiture Account = ____________.

    (a) ₹ 1,00,000 (b) ₹ 3,00,000

    (c) ₹ 96,000 (d) ₹ 3,96,000

21. Net balance in capital Reserve Account = ____________.

    (a) ₹ 2,96,000 (b) ₹ 80,000

    (c) ₹ 2,10,000 (d) ₹ 2,16,000

22. Net balance in Bank Account = ____________.

    (a) ₹ 2,40,00,000 (b) ₹ 2,40,12,000

    (c) ₹ 2,40,24,000 (d) ₹ 2,40,36,000

23. Balance Sheet Total = ____________.
    (a) ₹ 2,40,00,000 (b) ₹ 2,40,12,000
    (c) ₹ 2,40,24,000 (d) ₹ 2,40,36,000

24. When shares are forfeited, the share capital account is debited with _____ and the share
    Paid-up capital of shares forfeited; Called up capital of shares forfeited
    Called up capital of shares forfeited; Calls in arrear of shares forfeited
    Called up capital of shares forfeited; Amount received on shares forfeited
    Calls in arrears of shares forfeited; Amount received on shares forfeited

Use the following information for the question 25 to 29

B Ltd. issued 80,000 equity shares of ₹ 10 each, payable as under:

On application	₹ 3
On allotment	₹ 4
On first call	₹ 2
On final call	₹ 1

The applications received for 1,20,000 shares were dealt with as under:

- Applicants of 20,000 shares were allotted in full.
- Applicants of 80,000 shares were allotted 60,000 shares pro-rata.
- Applications for 20,000 shares were rejected

25. Amount received on application is ___________.
    (a) ₹2,40,000 (b) ₹3,60,000 (c) ₹5,60,000 (d) ₹8,00,000

26. Total excess money received as compared to the number of shares allotted =?
    a) ₹3,00,000 (b) ₹2,40,000 (c) ₹3,60,000 (d) ₹1,20,000

27. Amount to be refunded =?
    (a) Nil (b) ₹ 60,000 (c) ₹1,20,000 (d) ₹1,80,000

28. Amount of excess application money available for adjustment against allotment money?
    (a) Nil (b) ₹60,000 (c) ₹1,20,000 (d) ₹1,80,000

29. Amount of excess application money available for adjustment against call money?
    (a) Nil (b) ₹ 60,000 (c) ₹ 1,20,000 (d) ₹ 1,80,000

30. Which type of the following shares have the right to receive dividends unpaid in prior years, whenever earnings become adequate?

(a) Cumulative preference shares
(b) Participating preference shares
(c) Convertible preference shares
(d) Callable preference shares

31. Which of the following statements id false?

(a) Interest on calls-in-advance is paid from the date of receipt of advance to the date of relevant call
(b) Calls-in-advance are not entitled for any dividend
(c) According to table A, interest on calls-in-advance is paid at the rate of 6 % p.a.
(d) Payment of interest on calls-in-advance is at the discretion of the company

32. T Ltd. proposed to issue 6,000 equity shares of ₹ 100 each at a premium of 40 %. The minimum amount of application money to be collected per share as per the Companies Act, 1956*=?

(a) ₹ 5.00 (b) ₹ 6.00 (c) ₹ 7.00 (d) ₹ 8.40

33. Dividends are usually paid as a percentage of _______.

(a) Authorized share capital
(b) Net profit
(c) Paid-up capital
(d) Called-up capital

34. E Ltd. had allotted 10, 000 shares to the applicants of 14,000 shares on pro rata basis. The amount payable on application is ₹ 2. F applied for 420 shares. The number of shares allotted and the amount carried forward for adjustment against allotment money due from F =?

(a) 60 shares; ₹120
(b) 340 shares; ₹160
(c) 320 shares; ₹200
(d) 300 shares; ₹240

35. O Ltd. issued 10,000 equity shares of ₹ 10 each at a premium of 20% payable ₹ 4 on application (including premium), ₹ 5 on allotment and the balance on first and final call. The company received applications for 15,000 shares and allotment was made pro-rata. P, to whom 3,000 shares were allotted, failed to pay the amount due on allotment. All his shares were forfeited after the call was made. The forfeited shares were reissued to Q at par. Assuming that no other bank transactions took place, the bank balance of the company after effecting the above transaction = ?

(a) ₹ 1,14,000 (b) ₹ 1,32,000 (c) ₹ 1,20,000 (d) ₹ 1,00,000

36. A company forfeited 2,000 shares of ₹ 10 each (which were issued at par) held by Mr. John for non-payment of allotment money of ₹ 4 per share. The called-up value per share was ₹ 9. On forfeiture, the amount debited to share capital =?

(a) ₹ 10,000 (b) ₹ 8,000 (c) ₹ 2,000 (d) ₹ 18,000.

37. If forfeited shares (which were originally issued at a discount) are reissued at a premium, the amount of such premium will be credited to _______.

    (a) Share forfeiture account (b) Securities premium account

    (c) Capital reserve account (d) Discount on issue of shares account

38. The maximum capital beyond which a company is not allowed to raise funds, by issue of shares is its' _____________.

    (a) Issued share capital (b) Capital profits

    (c) Reserve profits (d) Provisions

39. As per the SEBI guidelines, on issue of shares, the application money should not be less than

    (a) 2.5% of the nominal value of shares

    (b) 205% of the issue price of shares

    (c) 25.0% of the nominal value of share

    (d) 25.0% of the issue price of shares

40. G Ltd. acquitted assets worth ₹ 7,50,000 from H Ltd. by issue of shares of ₹ 100 at a premium of 25 %. The number of shares to be issued by G Ltd. to settle the purchase consideration =?

    (a) 6,000 shares (b) 7,500 shares (c) 9,375 shares (d) 5,625 shares

41. D Ltd. issued 5,000 equity shares of ₹ 20 each at a premium of 20% payable ₹ 8 on application (including premium), ₹ 10 on allotment and the balance on first and final call. The company received applications for 7,500 shares and allotment was made pro-rata. E, to whom 1,500 shares were allotted, failed to pay the amount due on allotment. All he shares were forfeited after the call was made. The forfeited shares were reissued to F at par. Assuming that no other bank transactions took place, the bank balance of the company after affecting the above transactions =?

    (a) ₹ 1,14,000 (b) ₹ 1,32,000 (c) ₹ 1,20,000 (d) ₹ 1,00,000.

42. Capital reserves are credited out of

    (a) Balance in profit and loss account (b) Capital profits

    (c) Reserve profits (d) Provisions

43. The interest on calls-in-advance is paid for the period from the _________.

    (a) Date of receipt of application money to the date of appropriation

    (b) Date of receipt of allotment money to the date of appropriation

    (c) Date of receipt of calls-in-advance to the date of appropriation of the call

    (d) Date of appropriation to the date of dividend payment

44. As per Revised Schedule VI of the Companies Act, 1956,* under which of the following heads is 'Premium on issue of Preference Shares' shown in the balance sheet of a company?

(a) Non-current assets (b) Debentures

(c) Reserves and surplus (d) Current liabilities and provisions

45. Which of the following signifies the difference between par value and an issue price below par?

(a) Securities premium (b) Discount on issue of shares

(c) Calls in arrear (d) Calls in advance

46. The excess price received over the par value of shares, should be credited to

(a) Calls-in-advance account (b) Share capital account

(c) Reserve capital account (d) Securities premium account

47. The rate of discount on issue of shares cannot exceed _____ percent of the nominal value of the shares.

(a) 10 (b) 20 (c) 15 (d) 5

48. The Securities Premium Account should be shown under

(a) Share Capital (b) Current Liabilities

(c) Current Assets (d) Reserves and Surplus

Use the following information for questions 49 and 50

Consider the following data pertaining to W Ltd. as on March 31, 2009

Share Capital issued	
Subscribed Called-up (20,000 shares of ₹100 each)	₹20,00,000
Calls in arrear	₹10,000
Profit and loss account (Cr.) as on April 01, 2008	₹67,000
Profit for the year	₹1,90,610
The company wants to create a Debenture Redemption Reserve and to transfer ₹ 50,000 every year out of profits to redeem the debentures. The company declared 10% dividends.	

49. The amount of dividend declared =?

(a) ₹1,00,700 (b) ₹2,25,761 (c) ₹1,99,000 (d) ₹2,00,000

50. The balance of Profit and Loss Appropriation account transferred to Balance Sheet after effecting the above transactions =?

(a) ₹6,000 (b) ₹68,100 (c) ₹8,610 (d) ₹6,810

51. 51. If the forfeited shares are issued at a premium, the amount of the premium shall be credited to

(a) Profit and loss account (b) Capital reserve account

(c) Share forfeiture account (d) Securities premium account

52. IJK Ltd. issued 20,000 shares of ₹ 10 each at a premium of 20% on May 01, 2009, payable as follows:

On application	₹ 4.50 (inclusive of premium)
On allotment	₹ 2.50
On first and final call	₹ 5.00

Mrs. M, to whom 1,000 shares were allotted, has paid ₹ 5,000 on 01 June 2009. At the time of remitting the allotment money, she indicated that the excess money should be adjusted towards the call money. The directors of the company made the first and final call on October 31, 2009. The Company has a policy of paying interest on calls-in-advance. The amount of interest paid to Mrs. M on calls-in –advance=?

(a) ₹ 62.50 (b) ₹ 52.08 (c) ₹ 125.00 (d) ₹ 150.00

53. The following information pertains to X Ltd.

(a) Equity share capital called up ₹5,00,000 (b) Calls in arrear ₹40,000

(c) Calls in advance ₹25,000 (d) Proposed dividend 15%

54. Z Ltd. issued 10,000 shares of ₹ 10 each. The called up value per share was ₹ 8. The company forfeited 200 shares of Mr. A for non-payment of 1st call money of ₹ 2 per share. He paid ₹ 6 for application and allotment money. On forfeiture, the share capital account will be_______.

(a) Debited by ₹ 2,000 (b) Debited by ₹ 1,600

(c) Credited by ₹ 1,600 (d) Debited by ₹ 1,200

55. B Ltd. Issued shares of ₹ 10 each at a discount of 10%. Mr. C purchased 30 shares and paid ₹ 2 on application but did not pay the allotment money of ₹ 3. If the company forfeited his entire shares, the forfeiture account will be credited by ___________.

(a) ₹ 90 (b) ₹ 81 (c) ₹ 60 (d) ₹ 54

Use the following information for questions 56 and 57

B Ltd. invited applications for 5,000 shares of ₹ 10 each at a premium of ₹ 2 per share payable as follows:

On application	₹ 5
On allotment	₹ 4
On final call	₹ 3

Allotment was made on pro rata basis to the applicants of 6,000 shares. Mr. C to whom 60 shares were allotted, failed to pay allotment money and call money. Mr. D the holder of 100 shares, failed to pay call money. All these shares were forfeited after proper notice.

56. On forfeiture, the amount credited to share allotment account =?

    (a) ₹ 480 (b) ₹ 640 (c) ₹ 180 (d) ₹ 400

57. On forfeiture, the amount credited to share forfeiture account+?

    (a) ₹ 300 (b) ₹ 880 (c) ₹ 320 (d) ₹ 940

58. Which of the following statements is **false**?

    (a) Shares can be issued for cash or any other consideration

    (b) In the event of over subscription, excess amount has to be refunded or a pro rata allotment is to is to be made

    (c) A company must receive a minimum of 90% subscription against the entire issue as per the SEBI guidelines.

    (d) The share application money is automatically converted to share capital.

59. A company invited applications for 25,000 equity shares of ₹ 10 each and received 30,000 applications along with the application money of ₹ 4 per share. Which of the following alternatives can be followed?

    (I) Refund the excess applications.

    (II) Make pro rata allotment to all the applicants, and refund the excess application money.

    (III) Not to allot any share to some applicants, full allotment to some of the applicants and pro rata allotment to the rest of the applicants.

    (IV) Not to allot any shares to some applicants and make pro rata allotment to other applicants.

    (V) Make pro rata allotment to all the applicants and adjust the excess money received towards call money.

    (a) Only (II) above (b) Both (I) and (IV) above

    (b) All (I), (II), (III), (IV) and (V) above (d) Only (III) above

60. The document inviting offers from public to subscribe for the debentures or shares or deposits of a body corporate is known as _________.

    (a) Share certificate (b) Stock invest

    (c) Fixed deposit receipt (d) Prospectus

61. As per the Companies Act, forfeited shares account (not yet re-issued) shown under the heading will be _________.

    (a) Share Capital (b) Long-term borrowings

    (c) Reserves and Surplus (d) Current liabilities

62. The authorized capital of M Ltd. consists of both cumulative preference shares and equity shares. Each 5 % cumulative preference share has a par value ₹ 100. Each equity share has a par value ₹ 10. At the end of the year 2009-10 and 2010-11, the cumulative preference share capital balance was ₹ 2,00,000 and the equity share capital balance was ₹5,00,000.

    If dividend declarations totalled ₹ 8,000 and ₹ 15,000 in the year 2009-10 and 2010-11 respectively, the dividends allocated to the equity shareholders in the year 2010-11=?

    (a) ₹ 3,000 (b) ₹ 5,000 (c) ₹ 10,000 (d) ₹ 12,000

63. At the time of forfeiture of shares which were originally issued at a discount, the accounting entry involves ________.

    (I) A debit to share capital account with the called-up value of shares forfeited

    (II) A credit to share forfeiture account with the amount received on forfeited shares

    (III) A credit to Discount on issue of shares with the amount of discount allowed on forfeited shares.

    (IV) A credit to Calls-in-arrears with the amount due but not paid on forfeited shares

    (a) Both (I) and (V) above (b) Both (IV) and (III) above

    (c) Both (I) and (II) above (d) (I), (II), (III) and (IV) above.

64. As per The Companies Act, only preference shares, which are redeemable within ______can be issued.

    (a) 24 years (b) 22 Years (c) 30 years (d) 20 years

65. Which of the following is **not true**?

    (a) Loss on reissue of shares cannot be more than the gain on forfeiture of those shares

    (b) Where all the forfeited shares are not reissued the share forfeited account will show a credit balance equal to gain on forfeiture of shares not yet re-issued.

    (c) When the shares are forfeited, securities premium is debited along with share capital where premium has not been received

    (d) Where forfeited shares are re-issued at premium, the amount of such premium is credited to capital reserve account.

66. The subscribed share capital of S Ltd. Is ₹80,00,000 of ₹ 100 each. There were no calls in arrear till the final call was made. The final call made was paid on 77,500 shares. The calls in arrear amounted to ₹62,500. The final call per share?

    (a) ₹ 25 (b) ₹ 7.80 (c) ₹ 20 (d) ₹ 62.50

67. Which of the following should be **deducted** from the called-up share capital to find out paid-up capital?

(a) Calls-in-advance (b) Calls-in-arrears
(c) Share forfeiture (d) Discount on issue of shares

68. If a shareholder **does not** pay his dues on allotment, for the amount due, there will be a ________.

(a) Credit balance in the share allotment account
(b) Debit balance in the share forfeiture account
(c) Credit balance in the share forfeiture account
(d) Debit balance in the share allotment account

69. The discount allowed on re-issue of forfeited shares is debited to __________.

(a) General reserve account (b) Capital reserve account
(c) Revaluation reserve account (d) None of these.

70. Maximum amount that can be collected as premium as a percentage of face value?

(a) 20% (b) 30% (c) 40% (d) Unlimited

71. The company issued shares of ₹ 10 each at a premium of ₹ 2 payable as:

On application	-₹ 3
On allotment	-₹ 4 (including premium)
On first call	-₹ 3
On second and final call	-₹ 2

Mr. E who holds 100 shares failed to pay the first call money. The Company has forfeited the 100 shares after the first call. On forfeiture, the amount debited to share capital account =?

(a) ₹ 1,200 (b) ₹ 1,000 (c) ₹ 800 (d) ₹ 700

Use the following information for questions 72 and 73

D Ltd. issued 10,000 equity shares of ₹ 10 each at a premium of 20%. The share amount was payable as:

On application	-₹ 2
On allotment (including premium)	-₹ 5
On first call	-₹ 3
On second and final call	-₹ 2

Applications were received for 14,000 shares were allotted to applicants on pro-rata basis. E, who was allotted 300 shares, failed to pay the first call. On his subsequent failure to pay the second and final call, all his shares were forfeited. Out of the forfeited shares, 200 shares were re-issued @ ₹ 9 per share.

72. The amount transferred to capital reserve?
(a) ₹ 200 (b) ₹ 1,100 (c) ₹ 800 (d) ₹ 1,300

73. Balance in share forfeiture accounts =?
(a) ₹ Nil (b) ₹ 700 (c) ₹ 500 (d) ₹ 400

74. The following statements apply to equity/preference shareholders Which one of them applies only to Preference Shareholders?
Shareholders risk the loss of investment
Shareholders bear the risk of no dividends in the event of losses
Shareholders usually have the right to vote
Dividends are usually a fixed amount in every financial year

75. The Securities Premium amount may be utilized by a company for__________.
Writing off any loss on sale of fixed asset
Writing off any loss of revenue nature
Payment of dividends
Writing off the expenses/discount on the issue of debentures

76. Which of the following statements is false?
(a) A company can redeem its preference shares
(b) Preference shareholders are trade payable of a company
(c) The part of the authorized capital which can be called up only in the event of liquidation of a company is called reserve capital
(d) Capital redemption reserve can be utilized for issuing fully paid bonus shares

Use the following information for questions 2 and 3

The draft Balance Sheet of A Ltd. As on march 31, 2011 is as under:

Liabilities	₹	Assets	₹
Shares Capital:		Land and building	4,00,000
Equity Shares of ₹ 100 each	5,00,000	Plant and machinery	3,00,000
12%Preference shares of ₹ 10 each	3,00,000	Furniture & fixtures	2,50,000
Reserve and surplus:		Investments	2,25,000
General Reserve	1,50,000	Trade receivables	1,00,000
Profit and loss account	2,50,000	Inventories	1,50,000
18% Debentures	2,00,000	Cash	50,000
Trade payable	50,000		
Bank overdraft	25,000		
	14,75,000		14,75,000

The 12% preference shares are redeemable at a premium of 10%. The company wishes to maintain the cash balance at ₹ 25,000. For the purpose of redemption of preference shares, it proposed to sell the investments for ₹ 2, 00,000. The company proposes to issue sufficient number of equity shares of ₹ 100 each at a premium of 5% to raise required cash resources.

77. Total Cash required to effect the above decisions is _______________.

    (a) ₹3,30,000 (b) ₹3,55,000 (c) ₹25,000 (d) ₹1,05,000

78. Number of equity shares to be issued is ____________.

    (a) 1,500 (b) 1,000 (c) 950 (d) 1,500

79. S Ltd. issued 2,000 10% Preference shares of ₹ 10 each at par, which are redeemable at a premium of 10% for the purpose of redemption. The company issued 1,500 Equity Shares of ₹ 100 each at a premium of 20% per share. At the time of redemption of preference shares, he amount to be transferred by the company to the company to the capital redemption Reserve Account=?

    (a) ₹ 50,000 (b) ₹40,000 (c) ₹ 2,00,000 (d) ₹ 2,20,000

80. During the year 2005-06,T Ltd. issued 20,000 12% preference share of ₹10 each at a premium of 5% which are redeemable after 4 years at per. During the year 2010-2011, as the company did not have sufficient cash resources to redeem the preference shares, it issued 10,000 14% debentures of ₹10% each at a premium of 10%. At the time of redemption of 12% Preference shares, the amount to be transferred to capital redemption reserve=?

    (a) ₹ 90,00 (b) ₹ 1,00,000 (c) ₹ 2,00,000 (d) ₹ 1,10,000

81. According to Section 55 of the companies Act,* the amount In the securities premium A/c cannot be used for the purpose of

    (a) Issue of fully paid bonus shares
    (b) Writing off losses of the company
    (c) Writing off preliminary expenses
    (d) Writing off commission or discount on issue of shares

82. Which of the following can be utilized for redemption of preference shares?

    (a) The proceeds of fresh issue of equity shares
    (b) The proceeds of issue of debentures
    (c) The proceeds of issue of fixed deposit
    (d) all of the above

83. Which of the following statements is True?

(a) Capital redemption reserve cannot be used for payment of divined

(b) Capital profit realized in cash cannot be used for payment of divined

(c) Reserves created by revaluation of fixed assets are no permitted to be capitalized

(d) Dividend is payable on the calls paid in advance by shareholders

84. Consider the following information pertaining to E Ltd.

On September 4 2011, the company issued 12,000 7% Debentures having a face value of ₹ Each at a discount of 2.5% On September 12, the company issued 25,000, 8% Preference share of ₹ 100 each. On September 29, the company redeemed 30,000 6% preference shares of ₹ 100 each at a premium of 5% together with one month dividend thereon. Bank balance as on August 31, 2011 was ₹ 29, 25,000. After effecting the above transactions, the Bank balances as on September 30, 2011=?

(a) ₹ 33,15,000 (b) ₹33,30,000 (c) ₹ 33,45,000 (d) ₹ 34,30,000

85. Which of the following accounts can be used for transfer to capital redemption reserve Accounts?

(a) General reserve account (b) Forfeited shares account

(c) Profit prior to incorporation (d) Securities premium account

86. Preference shares amounting to ₹ 2, 00, 00 are redeemed at a premium of 5% by issue of shares amounting to ₹ 1, 00,000 at a premium of 10%. The amount to be transferred to capital redemption reserve=?

(a) ₹1, 05,000 (b) ₹1, 00,000 (c) ₹2,00,000 (d) ₹1,11,000

87. Securities premium cannot be used to……..

(a) Issue bonus shares (b) Redeem preference shares

(c) Write off preliminary expenses (d) Write off discount on issue of shares

88. A company cannot issue redeemable Preference shares for a period exceeding….

(a) 5 years (b) 10 years (c) 15 years (d) 20 years

Which of the following cannot be used for the purpose of creation of capital redemption reserve account?

(a) Profit and loss account (credit balance) (b) General reserve account

(c) Unclaimed dividend account (d) All of the above

89. Which of the following cannot be used for the purpose of creation of capital redemption reserve account?

(a) Profit and loss account (credit balance) (b) General reserve account

(c) Unclaimed dividend account (d) All of the above

Answers :-

1. (d)	2. (a)	3. (b)	4. (b)	5. (a)
6. (b)	7. (c)	8. (d)	9. (d)	10. (b)
11. (d)	12. (c)	13. (d)	14. (c)	15. (a)
16. (d)	17. (b)	18. (d)	19. (a)	20. (a)
21. (d)	22. (d)	23. (d)	24. (c)	25. (b)
26. (d)	27. (b)	28. (b)	29. (a)	30. (a)
31. (d)	32. (a)	33. (c)	34. (d)	35. (b)
36. (d)	37. (b)	38. (c)	39. (d)	40. (a)
41. (b)	42. (b)	43. (c)	44. (c)	45. (b)
46. (d)	47. (a)	48. (d)	49. (c)	50. (c)
51. (d)	52. (a)	53. (d)	54. (b)	55. (c)
56. (c)	57. (d)	58. (d)	59. (c)	60. (d)
61. (a)	62. (a)	63. (d)	64. (d)	65. (d)
66. (a)	67. (b)	68. (d)	69. (d)	70. (d)
71. (c)	72. (c)	73. (c)	74. (d)	75. (d)
76. (b)	77. (b)	78. (b)	79. (a)	80. (c)
81. (b)	82. (a)	83. (a)	84. (d)	85. (a)
86. (b)	87. (b)	88. (d)	89. (c)	

CHAPTER 11

Issue of Debentures

Introduction

In the earlier units of this chapter, we have studied the issue of share capital as a means of raising funds for financing the business activities. But with increasing and ever growing needs of the corporate expansion and growth, equity source of financing is not sufficient. Hence corporates turn to debt financing through various means. Issuing debt instruments by offering the same for public subscription is one of the sources of financing the business activities. Debt financing does not only help in reducing the cost of the capital but also helps in designing appropriate capital structure of the company. Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business.

Meaning

The Most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge has been created on any or on the entire assets of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Features of Debentures

1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security where interest falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.
4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

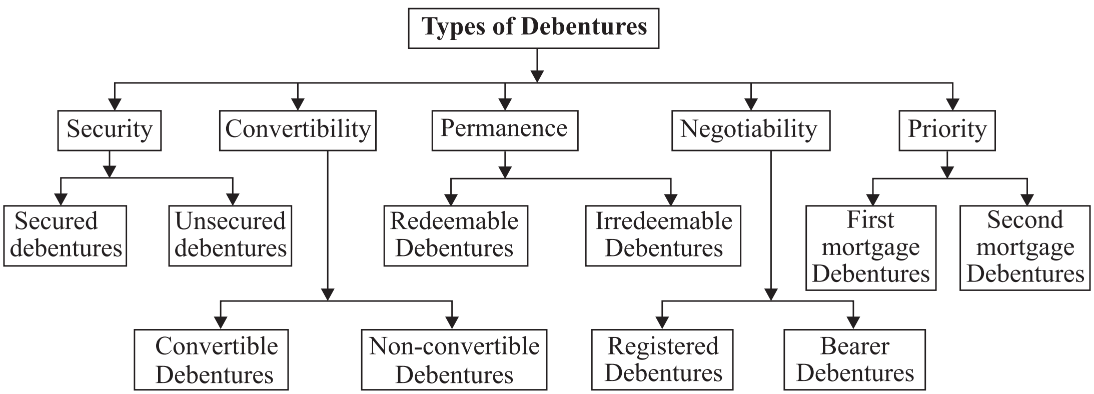
Distinction between Debentures and Shares

Debentures	Shares
1. Debenture holders are the lenders of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the Company	2. Shareholders have voting rights and consequently control the total affairs of the company.
3. Debenture interest is paid at a pre-determined fixed rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on equity shares is paid at a variable rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. Dividends are appropriation of profits and these are not deductible in determining taxable profit of the company.
5. There are different kinds of debentures, such as Secured /Unsecured; Redeemable / Irredeemable; Registered / Bearer; Convertible / non-convertible, etc.	5. There are only two kinds of shares – Equity Shares and Preference Shares.
6. In the Companies Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Companies Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.

7. Debentures can be converted into shares as per the terms of issue of debentures.	7. Shares cannot be converted into debentures in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, debenture holders get back their money as per the terms and conditions of redemption.	9. Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of liquidation, debenture holders are paid-off before the shareholders	10. At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.

Types of Debentures

The following are the types of debentures issued by a company. They can be classified on the basis of: (1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.



1. Security

(a) Secured Debentures: These debentures are secured by a charge upon some or all assets of the company. There are two types of charges; fixed charge and floating charge. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders The sale proceeds of these assets are utilized first for repaying debenture holders Floating charge generally covers all the assets of the company including future one.

(b) Unsecured or 'naked debentures': These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors

2. Convertibility

(a) Convertible Debentures: these are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the data of its issue; these debentures may be fully or partly convertible in future, these debenture holders gets chance to become the shareholders of the company

(b) Non-convertible debentures: These debentures are not convertible into equity shares at any point of time.

3. Permanence

(a) Redeemable debenture: These debentures are repayable as per the terms of issue, for example, after 8 years from the data of issue.

(b) Irredeemable debentures: these debentures are not repayable during the life time of the company .These are also called perpetual debentures. These are repaid only at the time of liquidation.

4. Negotiability

(a) Registered Debentures: These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the register of Debenture holders They are not easily transferable. The provisions of the companies Act 2013 are to be complied with for effecting transfer of these debentures. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.

(b) Bearer Debentures: these debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures Therefore; the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. Priority

(a) First Mortgage Debentures: These debentures are payable first out of the property charged.

(b) Second Mortgage Debentures: These debentures are payable after satisfying the first mortgage debentures.

Issue of Debentures

Accounting Entries for Issue of Redeemable Debentures

Issue of redeemable debentures can be categorized into the following:

Debenture issued at a par and redeemable at par or at a discount,
Debenture issued at a discount and redeemable at par or at discount.
Debenture issued at premium and redeemable at par or at discount.
Debenture issued at par and redeemable at premium.
Debenture issued at a discount and redeemable at premium.
Journal entries in each of the above cases are discussed below:

1. **Debenture issued at par redeemable at par**, the issue price is equal to par value, in this regard the following entries are recorded:

   (a) For receipt of allocation money:

   Bank A/c Dr.

   To Debenture Applications A/c

   (b) For transfer of applications money to debentures account:

   Debenture Applications A/c Dr.

   To ……. % Debenture A/c

Illustration 1

Amol Ltd. issued 40,00,000 9% debentures of ₹ 50 each payable on applications as per term mentioned in the prospectus and redeemable at par any time after 3 years from the date of issue. Record necessary entries for issue of debentures in the books of Amol Ltd.

Solutions:

Books of Amol Ltd. - Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c To Debenture Applications A/c (Debentures applications money received)		20,00,00,000	20,00,00,000
	Debenture Applications A/c to 9% Debenture A/c (Applications money transferred to 9% debentures account consequent upon allotment)		20,00,00,000	20,00,00,000

Illustration 2

Country Crafts Ltd. issued 20,00,000, 8% debentures of ₹100 each at par payable as ₹ 40 on application and ₹60 on allotment, redeemable at par after 5 years from the date of issue of debenture. Record necessary entries in the books of Country Crafts Ltd.

Solution:

Books of Country Crafts Ltd. - Journal				
Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture Application A/c (Debenture application money received)		8,00,00,000	 8,00,00,000
	Debenture Application A/c Dr. Debenture Allotment A/c Dr. To 8% Debentures A/c (Debenture application and call made consequent upon allotment money transferred to debenture account)		8,00,00,000 12,00,00,000	 20,00,00,000
	Bank A/c Dr. To Debenture Allotment A/c (Call made on allotment received)		12,00,00,000	 12,00,00,000

Note: The entry No. 2 above already covers the entry No. 4.

2. **Debenture issued at Discount and Redeemable at par or at discount:** When debentures are issued at discount, issue price will be less than par value. The difference between the two is considered as loss on issue on debentures and is to be written-off over the life of debentures. The entries with regards to issue are given below:

(a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) At the time of making allotment

(i) Debenture Application A/c Dr.

Discount on issue of debentures A/c Dr.

To …% Debentures A/c

Illustration 3

Atul Ltd. issued 1,00,00,000, 8% debenture of ₹ 100 each at a discount of 10% redeemable at par at the end of 10th year. Money was payable as follows:

₹ 30 on application

₹ 60 on allotment

Record necessary journal entries regarding issue of debenture.

Solution:

Books of Atul Ltd.

Journal

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture Application A/c *(Debenture application money received)*		30,00,00,000	30,00,00,000
	Debenture Application A/c Dr. To 8% Debentures A/c (Application money transferred to 8% *(Debentures account consequent upon allotment)*		30,00,00,000	30,00,00,000
	Debenture allotment A/c Dr. Discount on issue of debentures A/c Dr. To 8% Debentures A/c *(Amount due on allotment)*		60,00,00,000 10,00,00,000	70,00,00,000
	Bank A/c Dr. To Debenture Allotment A/c *(Money received consequent upon allotment)*		60,00,00,000	60,00,00,000

3. Debentures issued at Premium and Redeemable at Par or Discount

When debentures are issued at premium, the issue price is more than the par value. The premium is transferred to securities premium account. In this regards, the following journal entries are recorded:

When premium amount is received at the time of application;

(a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c.

(b) For transfer of application money at the time of allotment

Debenture Application A/c Dr.

To ---% Debenture A/c

To Securities Premium A/c.

When debentures are issued at par or at premium but redeemed at discount, then it means that the company will gain by paying less. This gain will not be recognised in the books of accounts at the time of issue of debentures as per the conservatism concept. Let us take an illustration.

Illustration 4.

Koinal Chemical Ltd issued 15,00,000, 10% debentures of ₹ 50 each at premium of 10% payable as ₹ 20 on application and balance on allotment. Debentures are redeemable at par after 6 years.

All the money due on allotment was called up and received. Pass the necessary journal entries when premium money is included in application money.

Solution:

Books of Koinal Chemical Ltd.
Journal
When premium money is received along with application money:

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture Application A/c *(Debenture application money received)*		30,00,00,000	 30,00,00,000
	Debenture Application A/c Dr. To 10% Debentures A/c To Securities Premium A/c (*Application money transferred to 10% debentures account and consequent upon allotment)*		30,00,00,000	 2,25,00,000 75,00,000
	Debenture allotment A/c Dr. To 10% Debentures A/c *(Amount due on allotment*)		5,25,00,000	 5,25,00,000
	Bank A/c To Debenture Allotment A/c *(Call made consequent upon allotment money received)*		5,25,00,000	 525,00,000

4. Debenture issued at par and redeemable at premium

Where debentures are to be redeemed at premium, an extra entry is to be made at the time of issue and allotment of debentures. This extra entry is to be passed for providing premium payable on redemption. Debenture Redemption Premium Account is a personal account which represents a liability of the company in respect of premium payable on redemption. In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debentures at the time of allotment of debentures. Following journal entries are recorded in this regard:

(a) For receipt of applications money

Bank A/c Dr.

To Debenture application A/c

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture of application A/c Dr.

To…..% Debenture A/c

(ii) Call made consequent upon allotment.

Debenture Allotment Dr.

Loss on issue of debentures A/c Dr. [Equal to Debenture Redemption premium]

To… % Debenture A/c

To Debenture redemption premium A/c

Instead of passing the separate entries, a compound entry can also be passed as follows:

Bank A/c Dr.

Loss on issue of debenture A/c Dr.

To…. % Debenture A/c

To Debenture Redemption Premium A/c

Illustration 5:

Modern Equipments Ltd. Issued 2, 00,000 12% Debentures of ₹ 1,000 payable as follows:

On applications	₹ 300
On allotment	₹ 700

The debenture was fully subscribed and all the money was duly received. As per the terms of issue, debentures are redeemable at ₹1,100 per debenture. Record necessary entries regarding issue debentures.

Solution:

	Books of Modern Equipment's Ltd. Journal				
Date	Particulars		L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c To 12% Debenture application A/c (Debenture application money received	Dr.		6,00,00,000	 6,00,00,000
	12% Debentures applications A/c To 12% Debenture A/c (Applications money transferred to 12% Debentures account consequent to allotment)	Dr.		6,00,00,000	 6,00,00,000
	12% Debentures Allotment A/c Loss on issue of Debentures A/c To 12% Debentures A/c To Debenture redemption premium A/c (call made on allotment of debentures redeemable at premium	Dr. Dr.		14,00,00,000 2,00,00,000	 14,00,00,000 2,00,00,000
	Bank A/c To 12% Debenture allotment A/c (Call made consequent upon allotment money received)	Dr.		14,00,00,000	14,00,00,000

5. Debenture Issued at discount and redeemable at premium:

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price the issue price is treated as discount/ loss on issue of debenture. Suppose, a 10% debentures of ₹ 1,000 is issued at a discount of ₹ 100 and redeemable at a premium ₹ 1,005 = ₹ per debenture, the amount of loss will be equal to ₹ 900 – ₹ 1,005 = ₹ This is to be treated as loss on issue. It is to be noted that premium on redemption of debentures is also credited by ₹ 5.

(a) For the receipt of application money

Bank A/c Dr.

To Debentures Applications A/c

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c Dr.

To % Debenture A/c

(ii) Call made consequent upon allotment of debentures at discount and redeemable at premium.

Debenture Allotment A/c Dr.

Discount/Loss on issue of debenture A/c Dr.

[Amount equal to the discount on issue of debenture plus Premium on redemption]

To % Debenture Redemption Premium A/c

(iii) For receipt of call made on allotment

Bank A/c Dr.

To Debenture Allotment A/c

Instead of passing the separate entries, a compound entry can be passed.

Bank A/c Dr.

Discount /Loss on issue of debenture A/c Dr.

To % Debentures A/c

To Debentures redemption premium A/c

Illustration 6

Agrotech Ltd. Issued 1, 40, 00,000 9% debentures of ₹100 each at a discount of 6 % redeemable at a premium of 5% after 3 years payable as: ₹ 50 on application and ₹ 44 on allotment. Record necessary journal entries for issue of debentures.

Solution

	Books of Agrotech Ltd. Journal			
Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture Applications A/c (Debenture applications money Received)		70,00,00,000	 70,00,00,000
	Debenture Applications A/c Dr To 9 % Debentures A/c (Applications money transferred to 9 % debenture account)		70,00,00,000	 70,00,00,000
	Debenture Allotment A/c Dr. Loss on issue of debentures A/c To 9% Debenture A/c To Debenture redemption premium		61,60,00,000 15,40,00,000	 70,00,00,000 7,00,00,000

	A/c (Call made consequent upon allotment of debentures issued at discount and re-deemable at premium)			
	Bank A/c Dr. To Debenture Allotment A/c (Allotment amount received)		61,60,00,000	61,60,00,000

Working Notes

Loss on issue of debentures =Amount of discount on issue + premium payable on redemption = 6% of ₹ 1, 40,00,000 + 5% of ₹ 1,40,00,00,000 = ₹ 8, 40,00,000 + ₹ 7,00,00,000= ₹ 15,40,00,000

6. Debentures Issued at premium and redeemable at premium

In this situation the issue price is more than par value and also redemption value is more than par value. The premium received at the time of issue of debentures is credited to securities premium account and premium paid at the time of redemption is a loss to be provided at the time of issue of debentures. Suppose a 10 % debentures of ₹1,000 is issued at a premium of ₹ 100 and redeemable at a premium of ₹ of 5 per debenture. In the given case ₹ 100 is to be credited to Securities. Premium account and ₹ 5 will be the loss to be provided at the time of issue of debentures. It is to be noted that premium on redemption of debentures is also credited by ₹ 5.

(a) For the receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c Dr.

To----% Debentures A/c

(ii) Call made consequent upon allotment of debentures at premium and redeemable at premium

Debenture on issued of Debentures A/c Dr.

Loss on issue of debenture A/c Dr.

[Amount equal to the premium on redemption]

To … % Debentures A/c

To Securities premium A/c

To Premium on Redemption of Debentures A/c.

Accounting for Issue of Debentures Payable in Instalments

Just like shares, money payable on debentures may be paid either in full with application by instalment. Accounting entries will differ to some extent in either case?

Debenture payable in full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures , such as 10% Debentures Application Account or 12% Debenture. Applications Account. These accounts record moneys received from the applicants of debentures. If an issue of oversubscribed, these accounts can be used to record the refund of moneys to the unsuccessful applications. At the time of allotment of debentures. The amount in Debentures Applications Account is transferred to the respective Debentures Account. As in case of shares, debentures may also be issued at par, a premium, or at a discount

Debenture Issued at par

The debentures which are issued at par are issued at the same price as their nominal value. That is, if a debt with a nominal value of ₹ 100 is issued at par, the company receives ₹ 100

The accounting entries would be as follows:

(a)	When cash is received Dr. Bank Account Dr. To Debentures Applications Account (Being money received on .. debentures @ ₹ each)	
(b)	When excess money is refunded Dr. Debentures Applications Account Dr To Cash (Being excess money … debentures refunded as per board's Resolution No…. dated…..)	
(c)	When the debentures are allotted Dr. Debentures Applications Account Dr. To Debentures Account (Being the allotment of debentures of ₹… each as per Board's Resolutions No…… dated…..)	

Illustration 7

Simmons Ltd. Issued 10,000 12% Debentures of ₹ 100 each at par payable in full on applications by 1st April, applications were received for 11,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date.

You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

Solution

	In the books of Simmons Limited			
Date	Particulars		₹	₹
April 1	Bank A/c To 12% Debentures Applications A/c	Dr.	11,00,000	 11,00,000
April 7	12% Debentures applications A/c To Bank A/c	Dr.	1,00,000	 1,00,000
April 7	12% Debentures Application A/c To 12% Debentures A/c	Dr.	10,00,000	10,00,000

Debentures Issued at a premium

A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value that is if a debenture with a nominal value of ₹ 100 is issued at 10% premium, the company receives at ₹ 110 where the investor gets slightly less interest than stated in the debenture.

For example 12% Debenture of ₹ 100 issued at a premium of 10% The investor will get ₹1 p.a. for his investment of 110 therefore the effective rate of interest on investment is (12/111x 100) = 10.91%

> The premium on debentures is credited to 'Securities Premium Account "as Debenture " are covered in the definition of securities specified in the clause (h) of Section 2 of the securities Contracts (Regulation) Act, 1965. Therefore restriction of utilization of debentures (securities) premium will also be governed by Section 52 of the Companies Act. 2013.

The accounting entries would be as follows:

(a) When cash is received

Bank Account Dr.

(Nominal value plus premium)

To Debenture Application Account

(Being money received on ... debentures @ ₹ each including premium of ₹)

(b) When excess money is refunded

Debentures Application Account Dr.

To Bank Account

(Being refund of money on ….. debentures @ ₹ each as per board's Resolution) No.…

(c) When the debenture are allotted

Debentures Applications Account Dr.

To Debenture Account

To Securities premium Account

(Being the allotment of ….. debentures, premium transferred to Securities Premium Account, as per Board's Resolution No….. Dated….)

Illustration 8

Kapil Ltd. Issued 10,000 12% Debentures of ₹ 100 each at a premium of 10% payable in full on application by 1st march, 2011. The issue was fully subscribed and debentures were allotted on 9th March, 2011.

Pass necessary Journal Entries (including cash transactions).

Solution:

In the books of Kapil Limited

Journal Entries

Date	Particular		Dr. ₹	Cr. ₹
March1, 2011	Bank A/c To 12% Debentures applications A/c	Dr.	11,00,000	 11,00,000
March 9	12% Debentures Application A/c To 12% Debenture A/c To Securities Premium A/c	Dr.	11,00,000	 10,00,000 1,00,000

Debenture Issued at a Discount

The Companies Act does not impose any restriction on the price at which debenture can be issued. Unlike shares, there is no maximum limit for discount on issue of debenture. This is why it is very common for debentures to be issued at a discount. The debentures which are issued at a discount at a lower price than nominal value that is if a debenture with a nominal value of ₹ 100 is issued at 10% discount, the company receives ₹ 90 only. The issue of debentures at a discount slightly increases the true rate of interest payable, for example; 12% for a loan of ₹ 90. Therefore, the true rate of interest is (12/90x100) = 13.33%.

The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate. Like shares, Debenture Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "Discount on issue of Debentures Account. In the Balance sheet, Discount on issue of Debentures is shown on the Assets side under' other Non-current assets" In the subsequent years, Discount on issue of Debentures is written off proportionately by charging to the statement of profit and Loss.

The accounting entries would be as follows:

(a) When Cash is received

Bank Account Dr. [Actual cash received]

To Debentures Application Account

(Being money received on ……… debentures @ ₹…each)

(b) When excess money is refunded

Debentures Application Account Dr.

To Bank Account

(Being excess money on ... debentures refunded as per Board's Resolution No... dated ...)

(c) When the debentures are allotted

Debentures Application Account Dr. [Actual cash received]

Discount on Issue of Debentures Account Dr. [Discount on debentures]

To Debentures Account [Nominal value of debentures]

(Being the allotment of ... debentures of ₹.each @ ₹.... each as per Board's Resolution No. ... Dated ...)

The discount on issue of debentures is considered as incremental interest expense. The true expense (net borrowing cost) for a particular accounting period is, therefore, the total interest payment plus the discount written off.

Illustration 9

X Ltd. Issued 10,000 12% Debentures of ₹ 100 each at a discount of 10% payable in full on application by 31st May, 2011. Applications were received for 12,000 debentures. Debentures were allotted on 9th June, 2011. Excess monies were refunded on the same date. Pass necessary Journal Entries.

Solution:

	In the books of X Limited Journal Entries			
Date 2011	Particulars		Dr. ₹	Cr. ₹
May 31	Bank A/c To 12% Debentures Application A/c (Being money received for 12,000 debentures @ ₹ 90 each)	Dr.	10,80,000	10,80,000
June 9	12% Debentures Application A/c To Bank A/c (Being excess money on 2,000 debentures @ ₹ 90 refunded as per Board's Resolution No …. Dated ….)	Dr.	1,80,000	1,80,000

June 9	12% Debentures Application A/c Discount on Issue of Debentures A/c To 12% Debentures A/c (Being the allotment of 10,000 debentures of ₹ 100 each at a discount of ₹ 10 per Debenture as per Board's Resolution No... dated…)	Dr. Dr.	9,00,000 1,00,000	 10,00,000

Bank Account

Dr.					Cr.
Date	Particulars	₹	Date	Particulars	₹
31.5.2011	To 12% Debentures Application A/c	10,80,000	9.6.2011	By 12% Debentures Application A/c	1,80,000
			9.6.2011	By Balance c/d	9,00,000
		10,80,000			10,80,000

12% Debentures Account

Dr.					Cr.
Date	Particulars	₹	Date	Particulars	₹
9.6.2011	To Balance c/d	10,00,000	9.6.2011	By 12 % Debentures Application A/c	9,00,000
			9.6.2011	By Discount on Issue of Debentures A/c	1,00,000
		10,00,000			10,00,000

Dr. 12% Debentures Application Account Cr.

Date	Particulars	₹	Date	Particulars	₹
9.6.2011	To Bank A/c	1,80,000	31.5.2011	By Bank A/c	10,80,000
9.6.2011	To 12% Debentures A/c	9,00,000			
		10,80,000			10,80,000

Discount on Issue of Debentures Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2011	To 12% Debentures A/c	1,00,000	9.6.2011	By Balance c/d	1,00,000
		1,00,000			1,00,000

Issue of Debentures as Collateral Security

Collateral security means secondary or supporting security for a loan, which can be realized by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.

The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

Accounting Entries

There are two methods of showing these types of debentures in the accounts of a company.

Method 1

Under this method, no entry is made in the books of account of the company at the time of making issue of such debentures. In the 'Notes to Accounts' of Balance Sheet, the fact of the debentures being issued and outstanding is shown by a note under the liability secured.

*Illustration 1*0

X Ltd. obtains a loan from IDBI of ₹ 10,00,000, giving as collateral security of ₹ 15,00,000, 14%, First Mortgage Debentures.

Solution:

In the Notes of Accounts of Balance Sheet of X Ltd., it is shown as follows:

Notes to Accounts of X Limited as at … (includes)

Long Term Borrowings	₹
Secured Loan	
IDBI Loan	10,00,000

(Collaterally secured by issue of ₹ 15,00,000, 14% First Mortgage Debentures)

Method 2

Under this method, the following entry is made to record the issue of such debentures.

Debentures Suspense Account	Dr.
To Debenture Account	

(Being the issue of … debentures collaterally as per Board's Resolution No. … Dated)

The Debentures Suspense Account will appear on the assets side of the Balance Sheet and Debentures on the liabilities side of the Balance Sheet. When the loan is repaid, the entry is reversed in order to cancel it.

Illustration 11

Taking the same information of the above example, the entry on issue will be as follows:

Cr.			Dr.
Date	Particulars		₹
	Debentures Suspense A/c	Dr	15,00,000
	To 14% First Mortgage Debentures A/c (Being the issue of ₹15,00,000 debentures collaterally as per Board's Resolution No…Dated.		15,00,000

Balance Sheet of X Limited as at …. (Extracts)

	Particulars EQUITY AND LIABILITIES	Notes No.	₹	
1	Non-Current Liabilities Long Term Borrowings	1	25,00,000	
	ASSETS	Total	?	
2	Non-current Assets Other non-current asset	2	15,00,000	
3	Current Assets Cash and cash equivalent		10,00,000	
		Total	?	
Notes to accounts			₹	₹
1	Long Term Borrowings Secured Loan IDBI Loan 14% First Mortgage Debentures		10,00,000 15,00,000	25,00,000
2	Other non-current asset Debenture suspense Account (issue of ₹15,00,000 14 % First Debentures as collateral security as per contra)			15,00,000

It should be noted that the Method 1 is much more logical from the accounting point of view. Therefore it is advisable to follow Method 1.

Issue of Debentures in Consideration other than Cash

Just like shares, debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc. In this case, the following entries are passed.

(a) Sundry Assets Account Dr. To Sundry Liabilities Account To Vendors Account (Being the assets and liabilities taken over)	[Assets taken over] [Liabilities assumed] [Purchase consideration]
(b) Vendors Account Dr. To Debentures Account (Being the issue of …….debentures to satisfy purchase consideration)	

Illustration 12

X Company Limited issued 14% Debentures of the nominal value of ₹ 10,00,000 as follows:

To sundry persons for cash at 90% ₹ 5, 00,000 nominal.

To a vendor for ₹ 2, 00,000 for purchase of fixed assets – ₹ 2, 50,000 nominal.

To the banker as collateral security for a loan of ₹ 1,00,000 – ₹ 2,50,000 nominal.

Pass necessary Journal Entries

Solution:

In the books of X Company Ltd.

Journal Entries

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c To Debentures Application A/c (Being the application money received on 5,000 debentures @ ₹ 90 each)	Dr.	4,50,000	 4,50,000
	Debentures Application A/c Discount on issue of Debenture A/c To 14% Debentures A/c (Being the issue of 5,000 14% debentures @ 90% as per Board's Resolution No…..dated….)	Dr. Dr.	4,50,000 50,000	 5,00,000
(b)	Fixed Assets A/c To Vendor A/c (Being the purchase of fixed assets from vendor)	Dr.	2,00,000	 2,00,000

	Vendor A/c Discount on Issue of Debentures A/c To 14% Debentures A/c (Being the issue of debentures of ₹ 2,50,000 to vendor to satisfy his claim)	Dr. Dr.	2,00,000 50,000	 2,50,000
(c)	Bank A/c To Bank Loan A/c (See Note) (Being a Loan of ₹ 1,00,000 taken from bank by issuing debentures of ₹ 2,50,000 as collateral security)	Dr.	1,00,000	 1,00,000

Note: Not entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet the fact that the debentures being issued being as collateral security and outstanding are shown under the respective liability.

Treatment of Discount loss on issue of Debentures

The discount on issue of debentures is amortized over period between the issuance date and redemption date. It should be written-off in the following manner depending upon the terms of redemption.

(a) If the debentures are redeemable after a certain period of time, say at the end of 5 or 10 years, the total amount of discount should be written-off equally throughout the life of the debentures (applying the straight line method). The main advantage of this method is that it spreads the burden of discount equally over the years

(b) If the debentures are redeemable at different dates, the total amount of discount should be written-off in the ratio of benefit derived from debentures loan in any particular year (applying the sum of the year's digits method). This method is suitable when debentures are redeemed by unequal instalments.

(c) If the debentures are irredeemable, the discount should be written-off gradually over a long period.

The accounting entries would be as follows:

Profit and Loss Account Dr.

To Discount on Issue of Debentures Account

(Being the amount of discount in issue of debentures written-off)

Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items are shown as Non-current/current assets depending upon the period for which it has to be written off.

Illustration 13

HDC Ltd issues 10,000 12% Debentures of ₹ 100 each at ₹ 94 on 1st January, 2008. Under the terms of issue, the debentures are redeemable at the end of 8 years from the date of the issue. Calculate the amount of discount to be written-off in each of the 8 years.

Solution:

Total amount of discount comes to ₹ 60,000 (₹ 6 X 10, 000). The amount of discount to be written-off in each year is calculated as under:

Year end	Debentures outstanding	Ratio in which discount to be written-off	Amount of discount to be written-off
1^{st}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
2^{nd}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
3^{rd}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
4^{th}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
5^{th}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
6^{th}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
7^{th}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500
8^{th}	₹ 10,00,000	1/8	$1/8^{th}$ of ₹ 60,000=₹ 7,500

Illustration 14

HDC Ltd. Issues 10,000, 12% Debentures of ₹ 100 each at ₹ 94 on 1st January, 2008. Under the terms of issue, 1/5th of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 2008. Calculate the amount of discount to be written-off from 2008 to 2012.

Solution:

Calculation of amount of discount to be written-off

At the Year end	Debentures outstanding	Ratio of benefit derived	Amount of discount to be written-off
2008	₹ 10,00,000	5	$5/15^{th}$ of ₹ 60,000 =₹ 20,000
2009	₹ 8,00,000	4	$4/15^{th}$ of ₹ 60,000= ₹ 16,000
2010	₹ 6,00,000	3	$3/15^{th}$ of ₹ 60,000= ₹ 12,000
2011	₹ 4,00,000	2	$2/15^{th}$ of ₹ 60,000= ₹ 8,000
2012	₹ 2,00,000	1	$1/15^{th}$ of ₹ 60,000= ₹ 4,000
	Total	15	₹ 60,000

Interest on Debentures

Interest payable on coupon debenture is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates applicable under tax rules from time to time. The companies will deposit the tax so deducted with income tax authorities.

Following accounting entries are to be recorded in this regard:

(1) For making interest due
Interest A/c Dr.
To Debenture holders' A/c

(2) For making payment of interest and deduction of tax at source (TDS)
Debentures holders A/c Dr.
To TDS Payable A/c
To Bank A/c

(3) For making payment of tax deducted at source
TDS payable A/c Dr.
To Bank A/c

(4) For transferring interest to profit and loss account
Profit and Loss A/c Dr.
To interest A/c

Illustration 15

A company issued 12% debentures of the face value of ₹ 2, 00,000 at 10-% discount on 1-1-2011. Debenture interest after deducting tax at source @ 10% was payable on 30th June and 31st December every year. All the debentures were to be redeemed after the expiry of five year period at 5% premium.

Pass journal entries for the accounting year 2011.

Solution:

	Journal Entries		Dr. (₹)	Cr. (₹)
1-1-2011	Bank A/c	Dr.	1,80,000	
	Debenture Discount A/c*	Dr.	20,000	
	Loss on Issue of Debentures A/c*	Dr.	10,000	
	To 12% Debentures A/c			2,00,000
	To Premium on Redemption of Debentures A/c			10,000
	(For issue of debentures at discount redeemable at premium)			

30-6-2011	Debenture Interest A/c To Debenture holders A/c To Tax Deducted at Source A/c (For interest payable)	Dr.	12,000	 10,800 1,200
	Debenture holders A/c Tax Deducted at Source A/c To Bank A/c (for payment of interest and TDS)	Dr. Dr.	10,800 1,200	 12,000
31-12-11	Debenture Interest A/c To Debenture holder A/c To Tax Deducted at Source A/c (For interest payable)	Dr.	12,000	 10,800 1,200
	Debenture holders A/c Tax Deducted at Source A/c To Bank A/c (For payment of interest and tax)	Dr. Dr.	10,800 1,200	 12,000
	Profit and Loss A/c To Debenture Interest A/c (for transfer of debenture interest to profit and loss account at the end of the year)	Dr.	24,000	 24,000
	Profit and Loss A/c To Debenture Discount A/c (for proportionate debenture discount written off, i.e., 20,000 x 1/5)	Dr.	4,000	 4,000
	Profit and Loss A/c To Loss on Issue of Debenture A/c (For proportionate loss in issue written off, i.e., 1/5x10,000)	Dr.	2,000	 2,000

*It may be noted that loss on issue of debenture is also written off in the ratio of debenture outstanding during different accounting years.

Note: ‘Debenture discount A/c’ and ‘Loss on issue of debenture A/c’ may be combined together under the heading ‘Loss on issue of debentures A/c.

SELF EVALUATION QUESTIONS

1. Which of the following statements is true?
   (a) A Debenture holder is an owner of the company
   (b) Debenture holder can get his money back only on the liquidation of the company
   (c) A debenture issued at a discount can be redeemed at a premium
   (d) A debenture holder receives interest only in the event of profits
2. Premium on redemption debentures account appearing in the balance sheet is _________.
   (a) A real account
   (b) A nominal account – income
   (c) A personal account
   (d) A nominal account –expenditure
3. Which of the following statements is false?
   (a) At maturity, debenture holders get back their money as per the terms and conditions of redemption
   (b) Debentures can be forfeited for non-payment of call money
   (c) In Companies balance sheet, debentures are shown under secured loans
   (d) Interest on debentures is charged against profits
4. Which of the following statements is false?
   (a) A company can issue convertible debentures
   (b) Debentures cannot be secured
   (c) A company can issue redeemable debentures
   (d) Debentures have no right to participate in profits over above their fixed interest
5. Debenture interest
   (a) Is payable only in case of profits
   (b) Accumulates in case of losses or inadequate profits
   (c) Is payable after the payment of preference dividend but before the payment of equity dividend
   (d) Is payable before the payment of any dividend on shares
6. F Ltd. Purchased Machinery from G Company for a book value of ₹ 4, 00,000. The consideration was paid by issue of 10% debentures of ₹ 100 each at a discount of 20%. The debenture account was credited with___________.
   (a) ₹ 4,00,000 (b) ₹ 5,00,000
   (c) ₹ 3,20,000 (d) ₹ 4,80,000

7. Loss on issue of debentures for 5 years is treated as____________.

   (a) Intangible asset

   (b) Current asset

   (c) Current liability

   (d) Other non-current asset

8. T Ltd. Has issued 14% Debentures of ₹, 20,00,000 at a discount of 10% on April 01,2009 and the company pays interest half-yearly on June 30, and December 31every year. On march 31, 2011, the amount shown as "interest accrued but not due" in the Balance Sheet will be

   (a) ₹ 70,000 (b) ₹ 2,10,000

   (c) ₹ 1,40,000 (d) ₹ 2,80,000

9. On May 30, 2010, U Ltd. issued 7% 10,000 convertible debentures of ₹ 100 each at a premium of 20%. Interest is payable on September 30 and March 31 every year. Assuming that the interest runs from the date of issue, the total amount of interest expenditure debited to profit and loss account for the year ended March 31, 2011 will be

   (a) ₹ 70,000 (b) ₹ 58,333

   (c) ₹ 84,000 (d) ₹ 64,167

10. Which of the following is/are true with respect to debentures?

    (a) They can be issued for cash

    (b) They can be issued for consideration other the cash

    (c) They cannot be issued as collateral security

    (d) Both (a) and (b) above

11. W Ltd. issued 20,000, 8% debentures of ₹ 10 each at par,, which are redeemable after 5 years at a premium of 20%. The amount of loss on redemption of debentures to be written off every year will be

    (a) ₹ 40,000 (b) ₹10,000

    (c) ₹ 20,000 (d) ₹ 8,000

12. When debentures are issued as collateral security, the final entry for recording the collateral debentures in the books is ____.

    (a) Credit Debentures A/c and debit Cash A/c.

    (b) Debit Debenture suspense A/c and credit Cash A/c.

(c) Debit Debenture suspense A/c and credit Debentures A/c.

(d) Debit cash A/c and credit the loan A/c for which security is given.

13. Which of the following is false?

(a) A company can issue redeemable debentures

(b) A company can issue debentures with voting rights

(c) A company can buy its own shares

(d) A company can buy its own debentures

14. Which of the following is false with respect to debentures?

(a) They can be issued for cash

(b) They can be issued for consideration other than cash

(c) They can be issued as collateral security

(d) They can be issued in lieu of dividends

15. Debentures can be _________________.

(I) Mortgage debenture or Simple Debentures.

(II) Registered Debentures or Bearer Debentures.

(III) Redeemable Debentures or Irredeemable Debentures.

(IV) Convertible Debentures or Non-convertible Debentures.

(a) Both (I) and (II) above

(b) Both (I) and (III) above

(c) Both (II) and (III) above

(d) All of (I), (II), (III), and (IV) above.

16. Which of the following statements is false?

(a) Debenture is a form of public borrowing

(b) It is customary to prefix debentures with the agreed rate of interest in case of fixed interest

(c) Debentures interest is a change against profits

(d) The issue price and redemption value of debentures cannot differ.

17. Interest on debentures is calculated on

(a) Its face value (b) Its issue price

(c) Its market price (d) Its redemption price

18. T Ltd. purchased land and building from U Ltd. for a book value of ₹, 2, 00,000. The consideration was paid by issue of 12%.Debenture of ₹ 100 each at a premium of 25%. The debenture account is credited with _______________. The amount of loss on redemption of debenture to be written off every year=?

    (a) ₹ 2,60,00 (b) ₹ 2,50,000

    (c) ₹ 2,40,000 (d) ₹1,60,000

19. P Ltd issued 5,000 12% debentures of ₹ 100 each at a premium of 10%, which are redeemable after 10 years at a premium of 20%. The amount of loss on redemption of debenture to be written off every year=?

    (a) ₹ 80,000 (b) ₹ 40,000

    (c) ₹ 10,000 (d) ₹8,000

20. Which of the following is true with regard to 10% Debenture issued at a discount of 20%?

    (a) The carrying amount of debentures gets reduced each year at rate of 20%

    (b) Issue price and the carrying amount of debentures are equal

    (c) At the time of redemption, the debenture holder will be paid the issue price

    (d) The face value and the carrying amount of debentures are equal

21. Which of the following is false?

    (a) Equity is owners' stake and the debenture is a debt

    (b) Rate of interest on debenture is fixed

    (c) Debenture holders get preferential treatment over the equity holders at the item of liquidation

    (d) Interest on debentures is an appropriation of profits

22. Discount on issue of debentures is a_______________.

    (a) Revenue loss to be charged in the year of issue

    (b) Capital loss to be written off from capital reserve

    (c) Capital loss to be written off over the tenure of the debentures

    (d) Capital loss to be shown as goodwill

23. When debentures are issued as collateral security against any loan then holder of such debentures is entitled to

    (a) Interest only on the amount of loan

    (b) Interest only on the face value of debentures

(c) Interest both on the amount of the loan and on the debentures

(d) None of the above.

24. When debentures are redeemable at different dates, the total amount of discount on issue of debentures should be written off

(a) Every year by applying the sum of the year's digit method

(b) Every year by applying the straight line method

(c) To profit and loss account in full in the year of final or last redemption

(d) To profit and loss account in full in the year of first redemption.

25. Which of the following is not a characteristic of Bearer Debentures?

They are treated as negotiable instruments

(b) Their transfer requires a deed of transfer

(c) They are transferable by mere delivery

(d) The interest on it is paid to the holder irrespective of identity.

Answers :-

1. (c)	2. (c)	3. (b)	4. (b)	5. (d)
6. (b)	7. (d)	8. (a)	9. (d)	10. (d)
11. (d)	12. (c)	13. (b)	14. (d)	15. (d)
16. (d)	17. (a)	18. (d)	19. (c)	20. (d)
21. (d)	22. (c)	23. (a)	24. (a)	25. (b)

CHAPTER 12

Interpretation of Financial Statements using Ratios

Introduction

A balance sheet informs a reader the balances of a Companies asset, liability, and equity at the end of the reporting period. A profit and loss statement reveals the financial performance during the year and the results. A statement of cash flows contains information about the flows of cash into and out of a company, and the uses to which the cash is put. The components of the balance sheet, profit and loss statement and cash flow statement are referred to as line items. Various kinds of assets (receivable, inventories, plant, equipment etc.), liabilities (payables, borrowings etc.) and shareholders' equity (capital, retained earnings etc).

Line items in the profit and loss statement are gross revenues, sales returns and allowances, net revenues, cost of goods sold, selling expenses, general and administrative expenses, profit etc. Cash flows and cash used in operating activities, investing activities, financial activities and their changes are the line items in the cash flow statement.

Ratio-analysis means the process of computing, determining and presenting the relationship of related items (and groups of items) of the financial statements. They are important tools for financial analysis. They provide information in the key areas of the entity in a summarized and concise form which helps to evaluate various aspects of a Companies operating and financial performance. A ratio is simply a mathematical comparison based on proportions. It can also be a percentage or a simple number/times.

The term financial ratio can be explained by defining how it is calculated and what the objective of this calculation is. A relationship expressed in mathematical terms between two individual figures or group of figures connected with each other in some logical manner and selected from financial statements of the concern. Objective for financial ratios is that all stakeholders (owners, investors, lenders, employees etc.) can draw conclusions about the Performance (past, present and future); Strengths & weaknesses of a firm; and can take decisions in relation to the firm.

Ratio analysis is based on the fact that a single accounting figure by itself may not communicate any meaningful information but when expressed as a relative to some other figure, it may definitely provide some significant information. Ratio analysis is not just comparing different numbers from the balance sheet, income statement, and cash flow statement. It is comparing the number against previous years, other companies, the industry, or even the economy in general for the purpose of financial analysis.

Generally, financial ratios are classified on the basis of function or test, on the basis of financial statements, and on the basis of importance. On the basis of function or test, the ratios are classified as liquidity ratios, profitability ratios, activity ratios and solvency ratios. Classification based on financial statements categorises them into balance sheet ratios (current ratio, debt-equity ratio etc.), statement of profit and loss (operating ratio, turnover ratio etc.) and composite ratios (fixed asset turnover ratio, earning per share ratio, debtors turnover ratio etc.).

On the basis of importance or significance, the most important ratios are called primary ratios and less important ratios are called secondary ratios. Secondary ratios are usually used to explain the primary ratios. Examples of primary ratios are return on capital employed ratio and net profit ratio because the basic purpose of these undertakings is to earn profit. Importance of ratios significantly varies among industries therefore each industry has its own primary and secondary ratios. A ratio that is of primary importance in one industry may be of secondary importance in another industry.

The following categories of ratios are explained in detailed in the subsequent pages.

(i) Liquidity Ratios

(ii) Capital Structure/Leverage Ratios

(iii) Activity Ratios

(iv) Profitability Ratios

1. Liquidity Ratios

The terms 'liquidity' and 'short-term solvency' are used synonymously. Liquidity or short-term solvency means ability of the business to pay its short-term liabilities. Inability to pay-off short-term liabilities affects its credibility as well as its credit rating. Continuous default on the part of the business leads to commercial bankruptcy. Eventually such commercial bankruptcy may lead to its sickness and dissolution.

Short-term lenders and creditors of a business are very much interested to know its state of liquidity because of their financial stake.

Traditionally, two ratios are used to highlight the business 'liquidity'. These are current ratio and quick ratio. Other ratios include cash ratio, interval measure ratio and net working capital ratio.

Let us work out exhaustive illustration of Home design Limited for better understanding of the different financial Ratios.

Home design Limited **Consolidated Balance Sheets**	**₹ in lakh**	
Assets	2 Feb 2012	2 Feb 2013
Current Assets:		
Current Assets		
Cash and cash equivalents	2,188	2,477
Short term investment including current maturities of long term investments	65	69
Receivables, net	1,072	920
Merchandise inventories	8,338	6,725
Other current assets	254	170
Total current assets	11,917	10,361
Property and equipment, at cost		
Land	5,560	4,972
Building	9,197	7.698
Furniture, fixtures and equipment	4,074	3,403
Leasehold improvements	872	750
Construction in progress	724	1,049
Capital leases	306	257
	20,733	18,129
Less Accumulated depreciation and amortization	3,565	2,754
Net property and equipment	17,168	15,375
Notes receivable	107	83

Cost in excess of the fair value of net assets acquired, net of accumulated amortization of ₹ 50 at February 2,2013 and ₹ 49 February3, 2012	575	419
Other assets	244	156
Total assets	30,011	26,394
Liabilities and shareholders' Equity		
Current Liabilities		
Accounts payable	4,560	3,436
Accrued salaries and related expenses	809	717
Sale taxes payable	307	348
Deferred revenue	998	851
Income taxes payable	227	211
Other accrued expenses	1,134	938
Total current liabilities	8,035	6,501
Long term debt, excluding current instalments	1,321	1,250
Other long term liabilities	491	372
Deferred income taxes	362	189
Total Liabilities	10,209	8,312
Shareholders' Equity		
Equity shares, par value ₹ 0.05 authorized: 10,000 shares, issued and outstanding 2,362shares at February 3,2013 and 2,346 shares at February 3,2012	118	117
Paid in capital	5,858	5,412
Retained earning	15,971	12,799
Accumulated other comprehensive loss	-82	-220
Unearned compensation	-63	-26
Treasury stock, at cost shares at February 2,2013	-2,000	-
Total shareholders' equity	19,802	18,082
Total liabilities and shareholders' equity	30,011	26,394

*

Home design Limited Consolidated Statements of Earnings		₹ in lakh,	Year Ended
	February 2,2013	**February 3,2012**	**January 28, 2011**
Net sales	58,247	53,553	45,738
Cost of merchandise sold	40,139	37,406	32,057
Gross profit	18,108	16,147	13,681
Operating expenses:			
Selling and store operating	11,180	10,163	8,513
Pre- opening	96	117	142
General and administrative	1,002	935	835
Total operating expenses	12,278	11,215	9,490
Operating income (expenses)			
Interest and investment income	79	53	47
Interest, expense	-37	-28	-21
Interest net	42	25	26
Earnings before provision for income taxes	5,872	4,957	4,217
Provision for income taxes	2,208	1,913	1,636
Net Earnings	₹ 3,664	₹ 3,044	₹ 2,581
Weighted average equity shares	2,336	2,335	2,315
Basic earnings per share	₹ 1,57	₹1,30	₹1,11
Diluted weighted average equity shares	2,344	2,353	2,352
Diluted earnings per share	₹ 1.56	₹ 1.29	₹1.10

(a) Current Ratios

The Current ratio is one of the best known measures of financial strength. It is most common measure of short term liquidity. It is also referred as the working capital ratio because net working capital is the difference between current assets and current liabilities.

Current Ratio = Current Assets / Current Liabilities

Where

Current Assets= Inventories + sundry Debtors Cash and Bank Balance + Receivables/ Accruals + Loans and Advances + Disposable Investments

Currents Liabilities = Creditors for goods and services + Short-term Loans + Bank Overdraft + Cash Credit + Outstanding Expenses + Provision for Taxation + Proposed Dividend + Unclaimed Dividend

The main question this ratio addresses is: 'Does your business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible losses in current assets?'

A generally acceptable current ratio is 2 to 1. But whether or not a specific ratio is satisfactory depends on the nature of the business and the characteristics of its current assets and liabilities.

Illustration 1

Looking at the statements of home-design, we compute current ratio as under:

$$\text{Current Ratio} = \frac{\text{Current assets} \quad = ₹\ 11{,}917}{\text{Current liabilities} = ₹\ 8{,}035} = 1.48 \text{ times}$$

Where, Current assets include cash and cash equivalents, net accounts receivable, marketable securities classified as current, inventories and prepaid expenses.

Current liabilities include accounts payable short term notes payable, current, maturities of on term debt unearned revenue, and other accrued liabilities.

(b) Quick Ratios

The quick Ratio is sometimes called the 'Acid Test' ratio and is one of the best measures of liquidity.

Quick Ratio or **Acid test Ratio** = Quick Assets/ Current Liabilities

Where

Quick Assets= Current Assets – Inventories

Current Liabilities = Creditors for goods and services + Short-term Loans + Bank Overdraft + Cash Credit + Outstanding Expenses + Provision for Taxation + Proposed Dividend + Unclaimed Dividend

The Quick Ratio is a much more conservative measure of short-term liquidity than the Current Ratio. It helps answer the questions. 'if all sales revenues should disappear, could my business meet its current obligations with the readily convertible quick funds on hand'?

Quick Assets consist of only cash and near cash assets, inventories are deducted from current assets on the belief that these are not near cash assets and also because in times of financial difficulty inventory may be saleable only at liquidation value. But in a seller market inventories are also near cash assets.

An acid test Ratio of 1:1 is considered satisfactory unless the majority of 'quick assets' are in accounts receivable, and the pattern of accounts receivable collection lags behind the schedule for paying current liabilities.

Illustration 2

Following the same example of Home design, we compute quick ratio as under

$$\text{Quick Ratio} = \frac{\text{Current Assets – Inventory}}{\text{Current Liabilities}} = \frac{11{,}917 - 8338}{8{,}035} = 0.45$$

(c) Cash Ratio/Absolute Liquidity Ratio

The cash ratio measures the absolute liquidity of the business. This ratio considers only the absolute liquidity available with the firm this ratio is calculated as:

$$\text{Cash Ratio} = \frac{\text{Cash + Marketable Securities}}{\text{Current Liabilities}}$$

A subsequent innovation in ratio analysis, the Absolute Liquidity Ratio eliminates any unknowns surrounding receivables. The Absolute Liquidity Ratio only tests short term liquidity in terms of cash and marketable securities.

(d) Net Working Capital Ratio:

Net working capital is more a measure of cash flow than a ratio. The result of this calculation must be a positive number. It is calculated as shown below:

Net Working Capital Ratio = Current Assets - Current Liabilities

(current liabilities exclude short-term bank borrowers)

Bankers look at Net Working Capital over time to determine a Companies ability to weather financial crises. Loans are often tied to minimum working capital requirements.

2. Capital Structure / Leverage Ratios

The capital structure/leverage ratios may be defined as those financial ratios which measure the long term stability and structure of the firm. These ratios indicates the mix of funds provided by owners and lenders and assure the lenders of the long term funds with regard to:

(i) Periodic payment of interest during the period of the loan and

(ii) Repayment of principal amount on maturity.

Therefore Leverage ratios are of two types:

Capital structure ratios and Coverage ratios.

Capital Structure Ratios provide an insight into the financing techniques used by a business and focus on the long term solvency position. From the balance sheet one can get only the absolute fund employed and its sources, but only capital structure ratios show the relative weight of different sources. Three popularly used capital structure ratios are equity ratio, debt ratio and debt to equity ratio.

(a) Equity Ratio

This ratio indicates proportion of owners' fund to total invested. The Equity ratio measures the proportion of the total assets that are financed by stockholders and not creditors.

$$\text{Equity Ratio} = \frac{\text{Shareholders' Equity}}{\text{Total Capital Employed}} = \frac{\text{Total shareholders' Equity}}{\text{Total Assets}}$$

(b) Debt Ratio

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Capital Employed}}$$

Total debt includes short and long term borrowings from financial institutions, debentures /bonds deferred payment arrangements for buying capital equipment's, bank borrowings, public deposits and any other interest bearing loan. Capital employed includes total debt and net worth.

Total debt includes short and long term borrowings from financial institutions, debentures /bonds deferred payment arrangements for buying capital equipment's, bank borrowings, public deposits and any other interest bearing loan. Capital employed includes total debt and net worth. This ratio is used to analyse the long term solvency of a firm.

(c) Debt to Equity Ratio

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Shareholder's Equity}}$$

Note: sometimes only interest bearing long term debt is used instead of total liabilities.

A high ratio means less protection for creditors. A low ratio, on the other hand, indicates a wider safety cushion (i.e. creditors feel the owners funds can help absorb possible losses of income and capital). This ratio indicates the proportion of debt fund in relation to equity. This ratio is very often referred in capital structure decision as well as in the legislation dealing with the capital structure decisions (i.e. issue of share and debentures). Lenders are also very keen to know this ratio since it shows relative weights of debt and equity.

Debt equity ratio is the indicator of firm's financial leverage. According to the traditional school, cost of capital fiertly decreases due to the higher dose of leverage, reaches minimum and thereafter increases, so infinite increase in leverage (i.e. debt-equity ratio) is not possible. Presently, there is no norm for maximum debt equity ratio. Lending institutions generally set their own norms considering the capital intensity and other factors.

Illustration 3

Looking at the statements of Home design, we compute debt to equity ratio as under:

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Shareholder's Equity}} = \frac{10{,}209}{19{,}802} = 51.56$$

(d) Debt to Total Assets Ratio

Debt to Total Assets Ratio measures the proportion of total assets financed with debt and, therefore the extent of financial leverage.

$$\text{Debt to Total Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Illustration 4

Looking at the above statements we compute debt to total assets ratio as under:

$$\text{Debt to Total Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}} = \frac{10{,}209}{30{,}011} = 34.02$$

Coverage Ratios

Coverage ratios measure the firm's ability to service the fixed liabilities. These ratios establish the relationship between fixed claims and what is normally available out of which these claims are to be paid. The following are important coverage ratios:

(a) Debt Service Coverage Ratio

It is the amount of cash flow available to meet annual interest and principal payments on debt. Lenders are interested in debt service coverage to judge the firm's ability to pay off current interest and instalments.

Debt Service Coverage Ratio = Annual interest on Long Term Loans & Liabilities + Annual Instalments payable on Long Term Loans & Liabilities

Or Earnings available for [debt service interest + Instalments]

Earning for debt service = Net profit+ Non cash operating expenses like depreciation and other amortizations+ Non-operating adjustment like loss on sale of + Fixed assets+ interest on Debt Fund.

(e) Interest Coverage Ratio

Interest coverage ratio is also known as 'times interest earned ratio' indicates the firm's ability to meet interest and other fixed- charge) obligations. This ratio is computed as:

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest}}$$

Earnings before interest and taxes are used in the numerator of this ratio because the ability to pay interest is not affected by tax burden as interest on debt funds is deductible expense. This ratio indicates the extent to which earning may fall without causing any embarrassment to the firm regarding the payment of interest charges.

A high interest coverage ratio means that an enterprise can easily meet its interest obligations even if earnings before interest and taxes suffer a considerable decline. A lower ratio indicates excessive use of debt or inefficient operations.

Illustration 4

Looking at the above statements we compute debt to total assets ratio as under:

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest}} = \frac{5{,}830}{37} = 157.57$$

(f) Preference Dividend Coverage Ratio

This ratio measures the ability of a firm to pay dividend on preference shares which carry a stated rate of return. This ratio is computed as:

$$\text{Preference Dividend Coverage Ratio} = \frac{\text{EAT}}{\text{Preference dividend liability}}$$

Earnings after tax is considered because unlike debt on which interest is charged on the profit of the firm, the preference dividend is treated as appropriation of profit.

This ratio indicates margin of safety available to the preference shareholders A higher ratio is desirable from preference shareholders point of view.

(g) Capital Gearing Ratio:

In addition to debt equity ratio, sometimes capital gearing ratio is also calculated to show the proportion of fixed interest (dividend) bearing capital to funds belonging to equity shareholders It is computed by dividing the common stockholders' equity by fixed interest or dividend bearing funds.

$$\text{Capital Gearing Ratio} = \frac{\text{(Preference Share Capital + Debentures + Long + Term)}}{\text{(Equity share capital + Reserves \& Surplus – Losses)}}$$

Analysing capital structure means measuring the relationship between the funds provided by common stockholders and the funds provided by those who receive a periodic interest or dividend at a fixed rate.

A company is said to be low geared if the larger portion of the capital is composed of common stockholders' equity. On the other hand, the company is said to be highly geared if the larger portion of the capital is composed of fixed interest/dividend bearing funds.

3. Activity Ratios

The activity ratios are also called the turnover ratio or performance ratios. These ratios are employed to evaluate the efficiency with which the firm manages and utilizes its assets. For this reason, they are often called Asset management ratios these ratios usually indicate the frequency of sales with respect to its assets. These assets may be capital assets or working capital or average inventory.

These ratios are usually calculated with reference to sales/cost of goods sold and are expressed in terms of rate or times. Some of the important activity ratios are as follows:

(a) Capital Turnover Ratio

$$\text{Capital Turnover Ratio} = \frac{\text{Sales}}{\text{Capital Employed}}$$

This ratio indicates the firm's ability of generating sales per rupee on long term investment the higher the ratio, the more efficient is the utilization of owner's and long term creditor's funds.

(b) Fixed Assets Turnover Ratio

It measures the efficiency with which the firm uses its fixed assets.

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Capital Assets}}$$

A high fixed assets turnover ratio indicates efficient utilization of fixed assets in generating sales. A firm whose plant and machinery are old may show a higher fixed assets turnover ratio than the firm which has purchased them recently.

Illustration 6: We compute the fixed assets turnover ratio of Home design as under:

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Average Net Fixed Assets}} = \frac{58{,}247}{16{,}272} = 3.5 \text{ times}$$

$$\text{Average Fixed Assets} = \frac{\text{Closing + Opening}}{2} = \frac{17{,}168 + 15{,}375}{2} = 16{,}272$$

(c) Total Asset Turnover Ratio

This ratio measures the efficiency with which the firm uses its total assets. This ratio is computed as:

$$\text{Total Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Average Total Assets}}$$

$$\text{Total Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Average Total Assets}} = \frac{58{,}247}{28{,}203} = 2.07 \text{ times}$$

(d) Working Capital Turnover:

$$\text{Working Capital Turnover Ratio} = \frac{\text{Sales}}{\text{Working Capital}}$$

Working Capital Turnover is further segregated into inventory Turnover, Debtors Turnover and Creditors Turnover

Inventory Turnover Ratio: This ratio also known as stock turnover ratio establishes the relationship between the cost of the goods sold during the year and average inventory held during the year. It measures the efficiency with which a firm utilizes or manages its inventory. It is calculated as follows.

$$\text{Inventory Turnover Ratio} = \frac{\text{Sales}}{\text{Average Inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

Very often inventory turnover is calculated as inventory to cost of sales instead of sales. In that case inventory turnover will be calculated as:

$$\frac{\text{Cost of Sales}}{\text{Average Stock}}$$

This is most widely used for calculating inventory turnover ratio. In the case of inventory of raw material the inventory ratio is calculated using the following formula:

$$\frac{\text{Raw Material Consumed}}{\text{Average Raw Material Stock}}$$

This ratio indicates that how fast inventory is used or sold. A high ratio is good from the view point of liquidity and vice versa. A low ratio would indicate that inventory is not used/ sold/ lost and stays in a shelf or in the warehouse for a long time.

Illustration 8: Following the same example of Home design, we may compute inventory turnover ratio:

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \frac{40{,}139}{7{,}532} = 5.3 \text{ times}$$

$$\text{Average Inventory} = \frac{\text{Closing + Opening}}{2} = \frac{8{,}338 + 6{,}725}{2} = 7{,}532$$

Debtors Turnover Ratio: It is also known as Receivables Turnover ratio. In case firm sells goods on credit, the realization of sales revenue is delayed and the receivables are created. The cash is realized from these receivables later on. The speed with these receivables are collected affects the liquidity position of the firm, the debtor, turnover ratio throws light on the collection and credit policies of the firm. It measures the efficiency with which management is managing its accounts receivables. It is calculated as follows:

$$\frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

As account receivables pertains only to credit sales. It is often recommended to compute the debtor's turnover with reference to credit sales instead of total sales. Then the debtor's turnover would be:

$$\frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

<u>Illustration 9:</u> Looking at the statements of Home design we compute Debtors turnover ratio as under.

$$\text{Debtor's Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}} = \frac{40{,}139}{7{,}532} = 5.3 \text{ times}$$

This ratio cannot be computed for Home design Limited, since the company accounts dot not provide break-up of the credit sales.

Debtor's Turnover ratio indicates the average collection period. However he average collection period can be directly calculated as follows:

$$\text{Average Collection Period} = \frac{\text{Average Accounts Receivable}}{\text{Average Daily Credit Sales}}$$

$$\text{Average Daily Credit Sales} = \frac{\text{Credit Sales}}{365}$$

The Average collection period measures the average number of days it takes to collect an account receivable. This ratio is also referred of as the number of days of receivable and the number of day's sales in receivables.

Creditor's turnover Ratio: This ratio is calculated on the same lines as receivable turnover ratio is calculated. This ratio shows the velocity of debt payment by the firm. It is calculated as follows:

$$\text{Creditors Turnover Ratio} = \frac{\text{Annual Net Credit Purchase}}{\text{Average Accounts Payable}}$$

A low creditor's turnover ratio reflects liberal credit terms granted by supplies. While a high ratio shows the accounts are settled rapidly.

$$\frac{\text{Credit Purchase}}{\text{Average Accounts Receivable}}$$

Similarly, average payment period can be calculated using:

$$\frac{\text{Average Accounts Payable}}{\text{Average Daily Credit Purchases}}$$

In determine the credit policy, debtor's turnover and average collection period provide a unique guideline. The firm can compare what credit period it receives from the suppliers and what it offers to the customers. Also it can compare the average credit period offered to the customers in the industry to which it belongs.

4. Profitability Ratios

The profitability ratios measure the profitability or the operational efficiency of the firm. These ratios reflect the final results of business operations. They are some of the most closely watched and widely quoted ratios. Management attempts to maximize these ratios to maximize firm value.

The results of the firm can be evaluated in terms of its earnings with reference to a given level of assets or sales or owner's interest etc. Therefore, the profitability ratios are broadly classified in four categories:

Profitability ratios required for analysis from owners' point of view

Profitability ratios based on assets/investments

Profitability rations based on sales of the firm

Profitability ratios based on capital market information.

Profitability Ratios Required for Analysis from Owner's Point of View

(a) Return of Equity (ROE)

Return on Equity measures the profitability of equity funds invested in the firm. This ratio reveals how profitably of the owners' funds have been utilized by the firm. It also measure the percentage return generated to equity shareholders. This ratio is computed as:

$$\text{ROE Return on Equity} = \frac{\text{Profit After Taxes}}{\text{Net Worth}}$$

Return on Equity is one of the most important indicators of a firm's profitability and potential growth. Companies that boast a high return on equity with little or no debt are able to grow without large capital expenditures, allowing the owners of the business to withdraw cash and reinvest it elsewhere. Many investors fail to realize, however, that two companies can have the same return on equity, yet one can be a much better business.

Illustration 10: We may compute Home-design's return on equity ratio as follows.

$$\text{Return on Equity} = \frac{\text{Net Income After Interest \& Taxes}}{\text{Average Shareholders' Equity}} = \frac{3,664}{18,942} = 19.34\ \%$$

$$\text{Average Shareholders' Equity} = \frac{\text{Ending SE + Beginning SE}}{2} = \frac{19,802 + 18,082}{2} = 18,942$$

(b) Earnings Per Share

The profitability of firm from the point of view of ordinary shareholders can be measured in terms of number of equity shares. This is known as Earnings per share. It is calculated as follows:

$$\text{EPS Earnings per Share} = \frac{\text{Net Profit Available to Equity holders}}{\text{Number of ordinary Shares outstanding}}$$

(c) Dividend Per Share

Earnings per share as stated above reflect the profitability of a firm per share; it does not reflect how much profit is paid as dividend and how much is retained by the business. Dividend per share ratio indicates the amount of profit distributed to shareholders per share. It is calculated as:

$$\text{Dividend per Share} = \frac{\text{Total Profits distributed to equity share holders}}{\text{Number of equity share}}$$

(d) Price Earnings Ratio

The price earnings ratio indicates the expectation of equity investors about the earnings of the firm. It relates earnings to market price and is generally taken as a summary measure of growth potential of an investment, risk characteristics, shareholders orientation, corporate image and degree of liquidity. It is calculated as:

$$\text{PE Ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

(e) Dividend Payment Ratio

This ratio measures the dividend paid in relation to net earnings. It is determined to see to how much extent earnings per share have been retained by the management for the business. It is computed as:

$$\text{Dividend Payment Ratio} = \frac{\text{Dividend per Equity Share}}{\text{Earnings per share}}$$

Illustration 11: If Home-design Limited's dividend for the year was rs 0.22, we can compute Dividend pay-out ratio as under:

$$\text{Dividend Pay-out Ratio} = \frac{\text{Cash Dividend per share}}{\text{Earnings per share}} = \frac{0.22}{1.57} = 0.14 \text{ or } 14\ \%$$

Profitability Ratios based on Assets/Investments:

(a) Return on Investment (ROI)

ROI is the most important ratio of all. It is the percentage of return on funds invested in the business by its owners. In short, this ratio tells the owner whether or not all the effort put into the business has been worthwhile. It compares earnings with capital invested in the company. The ROI is calculated as follows:

$$\text{Return on Investment} = \frac{\text{Return}}{\text{Capital Employed}} \text{ X } 100$$

$$= \frac{\text{Return}}{\text{Sales}} \text{ X } \frac{\text{Sales}}{\text{Capital Employed}} \text{ X } 100$$

$$\frac{\text{Sales}}{\text{Capital Employed}} = \text{Capital Turnover Ratio}$$

So, ROI = Profitability Ratio x Capital Turnover Ratio

ROI can be improved either by improving operating profit ratio or capital turnover or by both.

(b) Return on Capital Employed (ROCE) is another variation of ROI. It is calculated as follow:

$$\text{ROCE} = \frac{\text{EBIT x 100}}{\text{Capital Employed}}$$

Where, Capital Employed = Total Assets – Current Liabilities
or Fixed Assets + Working Capital

ROCE should always be higher than the rate at which the company borrows. Intangible assets (assets which have no physical existence like goodwill, patents and trademarks) should be included in the capital employed. But no fictitious asset should be included within capital employed.

(c) Return on Assets (ROA):

The profitability ratio is measured in terms of relationship between net profits and assets employed to earn that profit. This ratio measure the profitability of the firm in terms of assets employed in the firm. The ROA may be measured as follows:

$$\text{ROA} = \frac{\text{Net profit after taxes}}{\text{Average total assets}} \quad \text{or}$$

$$\text{ROA} = \frac{\text{Net profit after taxes}}{\text{Average tangible assets}} = \frac{\text{Net profit after taxes}}{\text{Average fixed assets}}$$

Illustration 12: we can compute Home-design's Return on assets ratio as under:

$$\text{ROA} = \frac{\text{Net income after interest and taxes}}{\text{Average total assets}} = \frac{3{,}664}{28{,}203} = 12.99\%$$

$$\begin{array}{c}\text{Average}\\\text{Total Assets}\end{array} = \frac{\text{Ending Total Assets + Beginning Total Assets}}{2} = \frac{30{,}001 + 26{,}394}{2} = 28{,}203$$

Application of Ratio Analysis in Financial Decision Making

A popular technique of analysing the performance of a business concern is that of financial ratio analysis. As a tool of financial management, they are of crucial significance. The importance of ratio analysis lies in the fact that it presents facts on a comparative basis and enables drawing of inferences regarding the performance of a firm. Ratio analysis is relevant in assessing the performance of a firm in respect of following aspects:

Financial Ratios for Evaluating Performance

(a) Liquidity Position: With the help of ratio analysis one can draw conclusions regarding liquidity position of a firm. The liquidity position of a firm would be satisfactory if it is able to meet its obligations when they become due. This ability is reflected in the liquidity ratios of a firm. The liquidity ratios are particularly useful in credit analysis by banks and other suppliers of short-term loans.

(b) Long-term Solvency: Ratio analysis is equally useful for assessing the long-term financial viability of a firm. This aspect of the financial position of a borrower is of concern to the long term creditors, security analysts and the present and potential owners of a business.

The long term solvency is measured by the leverage/capital structure and profitability ratios which focus on earning power and operating efficiency.

The leverage ratios, for instance, will indicate whether a firm has a reasonable proportion of various sources of finance or whether heavily loaded with debt in which case its solvency is exposed to serious strain.

Similarly, the various profitability ratios would reveal whether or not the firm is able to offer adequate return to its owners consistent with the risk involved.

(c) Operating Efficiency: Ratio analysis throws light on the degree of efficiency in the management and utilisation of its assets.

The various activity ratios measure this kind of operational efficiency. In fact, the solvency of a firm is, in the ultimate analysis, dependent upon the sales revenues generated by the use of its assets – total as well as its components.

(d) Overall Profitability: Unlike the outside parties which are interested in one aspect of the financial position of a firm, the management is constantly concerned about the overall profitability of the enterprise. That is, they are concerned about the ability of the firm to meet its short-term as well as long-term obligations to its creditors, to ensure a reasonable return to its owners and secure optimum utilisation of the assets of the firm. This is possible if an integrated view is taken and all the ratios are considered together.

(e) Inter-firm Comparison: Ratio analysis not only throws light on the financial position of a firm but also serves as a stepping stone to remedial measures. This is made possible due to inter-firm comparison/comparison with industry averages.

A single figure of particular ratio is meaningless unless it is related to some standard or norm. One of the popular techniques is to compare the ratios of a firm with the industry average. It should be reasonably expected that the performance of a firm should be in broad conformity with that of the industry to which it belongs.

An inter-firm comparison would demonstrate the relative position vis-a-vis its competitors. If the results are at variance either with the industry average or with those of the competitors, the firm can seek to identify the probable reasons and, in the light, take remedial measures.

Ratios not only perform post mortem of operations, but also serve as barometer for future. Ratios have predictive value and they are very helpful in forecasting and planning the business activities for a future. It helps in budgeting.

Conclusions are drawn on the basis of the analysis obtained by using ratio analysis. The decisions affected may be whether to supply goods on credit to a concern, whether bank loans will be made available, etc.

(f) Financial Ratios for Budgeting: In this field ratios are able to provide a great deal of assistance, budget is only an estimate of future activity based on past experience, in the making of which the relationship between different spheres of activities are invaluable.

It is usually possible to estimate budgeted figures using financial ratios. Ratios also can be made use of for measuring actual performance with budgeted estimates. They indicate directions in which adjustments should be made either in the budget or in performance to bring them closer to each other.

Limitations of Financial Ratios

(i) Diversified product lines: Many businesses operate a large number of divisions in quite different industries. In such cases ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.

(ii) Financial data are badly distorted by inflation: Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.

(iii) Seasonal factors may also influence financial data. Consider a company that deals in summer garments. It keeps a high inventory during October - January every year. For the rest of the year its inventory level becomes just 1/4th of the seasonal inventory level. So liquidity ratios and inventory ratios will produce biased picture. Year-end picture may not be the average picture of the business. Sometimes it is suggested to take monthly average inventory data instead of year end data to eliminate seasonal factors But for external users it is difficult to get monthly inventory figures. (Even in some cases monthly inventory figures may not be available).

(iv) To give a good shape to the popularly used financial ratios (like current ratio, debt-equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.

(v) Differences in accounting policies and accounting period: It can make the accounting data of two firms non-comparable as also the accounting ratios.

(vi) There is no standard set of ratios against which a firm's ratios can be compared. Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

(vii) It is very difficult to generalise whether a particular ratio is good or bad: For example, a low current ratio may be said 'bad' from the point of view of low liquidity, but a high current ratio may not be 'good' as this may result from inefficient working capital management.

(viii) Financial ratios are inter-related, not independent: Viewed in isolation one ratio may highlight efficiency. But when considered as a set of ratios they may speak differently. Such interdependence among the ratios can be taken care of through multivariate analysis. Financial ratios provide clues but not conclusions. These are tools only in the hands of experts because there is no standard ready-made interpretation of financial ratios.

CHAPTER 13

Corporate Governance

Financial statements are meant to capture the financial position and financial performance of the entities and provide this information to the users, particularly the shareholders. Accounting Standards evolved to ensure that financial statements are prepared in such a way. External Auditor governed by Auditing Standards is meant to provide an assurance that Financial Statements are indeed prepared according to Accounting Standards.

However, history is replete with instances of intentional manipulation of figures in the financial statements by the Management to conceal the poor performance and mislead users, particularly the shareholders. Billions of investment of millions of shareholders was wiped out when these entities collapsed since the days of Great Depression in 1920s to Global Financial Crisis in 2008. Intervening period is littered with financial frauds perpetuated by Enron, WorldCom, Parmalat, Barings Bank, Lehman Brothers, Satyam, dotcom bursts, Ponzi schemes, to name a few.

Accounting Standards leave enough scope for human interpretation. They recommend different ways of accounting for certain activities. Studies revealed how assets are overstated, liabilities and expenses are understated, and revenue recognition principles were misused to inflate the revenue etc., through varied interpretation of Standards, though not amounting to willful financial fraud.

Corporate Governance emerged as a set of principles to be accepted and practiced by the management. An entity's management is only a trustee on the behalf of the shareholders. Management should be committed ethical business conduct and be accountable to the shareholders. Financial reporting remains the primary form of accountability and providing a 'true and fair' picture of the financial position includes an ethical and moral component.

The attention these issues have drawn from the governments and corporate world can be seen from the number of reports published during last 25 years.

Cadbury Committee - The Financial Aspects of Corporate Governance (1992)

Greenbury Committee Report on Directors' Remuneration (1995)

Hampel Committee Report on Corporate Governance (1998)

The Combined Code, Principles of Good Governance and Code of Best Practice, London Stock Exchange (1998)

CalPErs' Global Principles of Accountable Corporate Governance (1999)

Blue Ribbon Report (1999)

King Committee - Corporate Governance (2002)

Sarbanes Oxley Act (2002)

Higgs Report: Role and effectiveness of non-executive directors (2003)

The Combined Code on Corporate Governance (2003)

ASX Corporate Governance Council Report (2003)

OECD Principles of Corporate Governance (2004)

The Combined Code on Corporate Governance (2006)

UNCTAD - Good Practices in Corporate Governance Disclosure (2006)

The Combined Code on Corporate Governance (2008)

Dotcom burst in early 90s triggered measures to improve corporate governance and before the dust settled down, Enron debacle in 2001 triggered bigger wave of corporate governance reforms. Before this dust settled down, global financial 2007-08 erupted and questioned the soundness of existing corporate governance practices.

It is argued by some that corporate governance measures so far focused on the supply side of corporate governance: i.e. what directors, managers, auditors, and lawyers must do to prevent the governance failures. This latest and most pervasive financial crisis perhaps hints that the focus must be on the demand side; 'removing obstacles to effective oversight by shareholders'. Shareholders must be both willing and able to vote against the board members who agree to issues like huge pay-outs to top management, reckless risk taking etc., and if needed to vote out board members who approve those plans.

Corporate Governance Framework

There is no single model of corporate governance. OECD defines it as "the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance".

Some authors have identified the following as four pillars of corporate governance.

Accountability that ensures that management is accountable to the Board, and Board is accountable to shareholders.

Fairness with reference to protect Shareholders rights, treating all shareholders including minorities, equitably and providing effective redress for violations- Probity and integrity

Transperancy in terms of ensuring timely, accurate disclosure on all material matters, including the financial situation, performance, ownership and corporate governance

Independence: Procedures and structures are in place so as to minimise, or avoid completely conflicts of interest; directors have a degree of independence from their executive colleagues on a board, internal auditors are independent of the colleagues they are auditing, external auditors are independent of their clients etc. Independence implies professionalism and professional behaviour.

An effective corporate governance framework requires a number of components: rights to enable shareholders to hold companies to account; the availability of information needed to assess the performance and governance of companies; and an expectation of certain behaviours on the part of companies, promulgated either through law or codes. In general, the law imposes basic standards of conduct and transparency while codes are more effective in encouraging best practice.

The three key constituents of corporate governance are the Board of Directors, the Shareholders and the Management.

The pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the stakeholders and directs and controls the management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in a transparent manner to all the stakeholders.

The shareholders' role in corporate governance is to appoint the directors and the auditors and to hold the board accountable for the proper governance of the company by requiring the board to provide them periodically with the requisite information in a transparent fashion, of the activities and progress of the company.

The responsibility of the management is to undertake the management of the company in terms of the direction provided by the board, to put in place adequate control systems and to ensure their operation and to provide information to the board on a timely basis and in a transparent manner to enable the board to monitor the accountability of management to it.

Constituents of Good Corporate Governance:

Role and powers of Board: the foremost requirement of good corporate governance is the clear identification of powers, roles, responsibilities and accountability of the Board, CEO and the Chairman of the board.

Legislation: a clear and unambiguous legislative and regulatory framework is fundamental to effective corporate governance.

Code of Conduct: it is essential that an organization's explicitly prescribed code of conduct are communicated to all stakeholders and are clearly understood by them. There should be some system in place to periodically measure and evaluate the adherence to such code of conduct by each member of the organization.

Board Independence: an independent board is essential for sound corporate governance. It means that the board is capable of assessing the performance of managers with an objective perspective. Hence, the majority of board members should be independent of both the management team and any commercial dealings with the company. Such independence ensures the effectiveness of the board in supervising the activities of management as well as make sure that there are no actual or perceived conflicts of interests.

Board Skills: in order to be able to undertake its functions effectively, the board must possess the necessary blend of qualities, skills, knowledge and experience so as to make quality contribution. It includes operational or technical expertise, financial skills, legal skills as well as knowledge of government and regulatory requirements.

Management Environment: includes setting up of clear objectives and appropriate ethical framework, establishing due processes, providing for transparency and clear enunciation of responsibility and accountability, implementing sound business planning, encouraging business risk assessment, having right people and right skill for jobs, establishing clear boundaries for acceptable behaviour, establishing performance evaluation measures and evaluating performance and sufficiently recognizing individual and group contribution.

Board Appointments: to ensure that the most competent people are appointed in the board, the board positions must be filled through the process of extensive search. A well-defined and open procedure must be in place for reappointments as well as for appointment of new directors

Board Induction and Training: is essential to ensure that directors remain abreast of all development, which are or may impact corporate governance and other related issues.

Board Meetings: are the forums for board decision making. These meetings enable directors to discharge their responsibilities. The effectiveness of board meetings is dependent on carefully planned agendas and providing relevant papers and materials to directors sufficiently prior to board meetings.

Strategy Setting: the objective of the company must be clearly documented in a long term corporate strategy including an annual business plan together with achievable and measurable performance targets and milestones.

Business and Community Obligations: though the basic activity of a business entity is inherently commercial yet it must also take care of community's obligations. The stakeholders must be informed about the approval by the proposed and on going initiatives taken to meet the community obligations.

Financial and Operational Reporting: the board requires comprehensive, regular, reliable, timely, correct and relevant information in a form and of a quality that is appropriate to discharge its function of monitoring corporate performance.

Monitoring the Board Performance: the board must monitor and evaluate its combined performance and also that of individual directors at periodic intervals, using key performance indicators besides peer review.

Audit Committee: is inter alia responsible for liaison with management, internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the board on the key issues.

Risk Management: risk is an important element of corporate functioning and governance. There should be a clearly established process of identifying, analysing and treating risks, which could prevent the company from effectively achieving its objectives. The board has the ultimate responsibility for identifying major risks to the organization, setting acceptable levels of risks and ensuring that senior management takes steps to detect, monitor and control these risks.

Corporate Governance in India

In India, corporate governance initiatives have been undertaken by the Ministry of Corporate Affairs (MCA) and the Securities and Exchange Board of India (SEBI). The first formal regulatory framework for listed companies specifically for corporate governance was established by the SEBI in February 2000, following the recommendations of Kumarmangalam Birla Committee Report. It was enshrined as Clause 49 of the Listing Agreement. Further, SEBI is maintaining the standards of corporate governance through other laws like the Securities Contracts (Regulation) Act, 1956; Securities and Exchange Board of India Act, 1992; and Depositories Act, 1996.

Thereafter SEBI had set up another committee under the chairmanship of Mr. N. R. Narayana Murthy, to review Clause 49, and suggest measures to improve corporate governance standards. Some of the major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures.

The Ministry of Corporate Affairs had appointed a Naresh Chandra Committee on Corporate Audit and Governance in 2002 in order to examine various corporate governance issues. It made recommendations in two key aspects of corporate governance: financial and non-financial disclosures: and independent auditing and board oversight of management. It is making all efforts to bring transparency in the structure of corporate governance through the enactment of Companies Act and its amendments.

Corporate Governance for Public Sector Companies

There are about 250 Central Public Sector Enterprises (CPSEs). Majority of these CPSEs, including Maharatnas, Navratnas and Miniratnas, are earning profit and have improved their financial performance over the years The Department of Public Enterprises (DPE) had issued guidelines on composition of Board of Directors of Central Public Sector Enterprises (CPSEs) in 1992. To bring in more transparency and accountability in the functioning of CPSEs, the Government in June, 2007 introduced, for an experimental period of one year, the Guidelines on Corporate Governance for CPSEs. These Guidelines were of voluntary nature. Since the issue of these guidelines, the CPSEs have had the opportunity to implement them for the whole of the financial year 2008-09. These Guidelines have been modified and improved upon based on the experience gained during the experimental period of one year. The Government have felt the need for continuing the adoption of good Corporate Governance Guidelines by CPSEs for ensuring higher level of transparency and decided to make these Guidelines mandatory and applicable to all CPSEs.

Apart from these instructions of DPE, the CPSEs are governed by the Companies Act, 2013 and regulations of various authorities like Comptroller and Auditor General of India (C&AG), Central Vigilance Commission (CVC), Administrative Ministries, other nodal Ministries, etc. The Right to Information Act 2005 is also applicable to the CPSEs.

Further, some principles of Corporate Governance are already in vogue in public sector because; (a) the Chairman, Managing Director and Directors are appointed independently through a prescribed procedure; (b) Statutory auditors are appointed independently by the C&AG; (c) Arbitrary actions, if any, of the Management can be challenged through writ petitions; (d) Remuneration of Directors, employees, etc. are determined on the basis of recommendations of Pay Committees constituted for this purpose; etc.

For the purpose of evolving Guidelines on Corporate Governance, CPSEs have been categorised into two groups, namely, (i) those listed on the Stock Exchanges; (ii) those not listed on the Stock Exchanges. In so far as listed CPSEs are concerned, they have to follow the SEBI Guidelines on Corporate Governance. In addition, they shall follow those provisions in these Guidelines which do not exist in the SEBI Guidelines and also do not contradict any of the provisions of the SEBI Guidelines.

The Board of Directors of the company shall have an optimum combination of Functional, Nominee and Independent Directors The number of Functional Directors (including CMD/MD) should not exceed 50% of the actual strength of the Board. The number of Nominee Directors appointed by Government/other CPSEs shall be restricted to a maximum of two. In case of a CPSE listed on the Stock Exchanges and whose Board of Directors is headed by an Executive Chairman, the number of Independent Directors shall be at least 50% of Board Members; and in case of all other CPSEs listed on Stock Exchange but without an Executive Chairman, or not listed CPSEs), at least one-third of the Board Members should be Independent Directors

The Board shall meet at least once in every three months and at least four such meetings shall be held every year. Further, the time gap between any two meetings should not be more than three months. A Director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a Director. Furthermore it should be a mandatory annual requirement for every Director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

The Board shall lay down a *code of conduct* for all Board members and senior management of the company. The code of conduct shall be circulated and also posted on the website of the company. All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by its Chief Executive.

Each CPSE shall constitute a *Remuneration Committee* comprising of at least three Directors, all of whom should be part-time Directors (i.e Nominee Directors or Independent Directors). The Committee should be headed by an Independent Director.

The role and responsibilities of the Audit Committee is the most important element of corporate governance framework. It is explained in detail.

Audit Committee

A qualified and independent Audit Committee consisting of minimum three Directors as members, out of which majority shall be Independent Directors shall be constituted. The Chairman of the Audit Committee shall be an Independent Director. All members of Audit Committee shall have knowledge of financial matters of Company, and at least one member shall have good knowledge of accounting and related financial management expertise. The Chairman of the Committee shall be present at Annual General Meeting to answer shareholder queries; provided that in case the Chairman is unable to attend due to unavoidable reasons, he may nominate any member of the Audit Committee. The Finance Director, Head of Internal Audit and a representative of the Statutory Auditor may be specifically invited to be present as invitees for the meetings of the Audit Committee as may be decided by the Chairman of the Audit Committee. The Company Secretary shall act as the Secretary to the Audit Committee.

Functions of Audit Committee shall include, Oversight of the Companies financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible, recommending to the Board the fixation of audit fees, approval of payment to statutory auditors, review of annual financial statements before submission to the Board for approval, changes, if any, in accounting policies and practices and reasons for the same, review of performance of internal auditors and adequacy of the internal control systems, review the functioning of the Whistle Blower Mechanism, review the follow up action on the audit observations of the C&AG audit, action taken on the recommendations of Committee on Public Undertakings (COPU) of the Parliament, provide an open avenue of communication between the independent auditor, internal auditor and the Board of Directors Commensurate with its role, the Audit Committee should be invested by the Board of Directors with sufficient powers to investigate any activity within its terms of reference, to seek information on and from any employee, to obtain outside legal or other professional advice, subject to the approval of the Board of Directors, to secure attendance of outsiders with relevant expertise, if it considers necessary, to protect whistle blowers

The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the Audit Committee whichever is greater, but a minimum of two independent members must be present.

Report on compliance with corporate governance guidance

There shall be a separate Section on Corporate Governance in each Annual Report of company, with details of compliance on Corporate Governance. The company shall obtain a certificate from either the auditors or practicing Company Secretary regarding compliance of conditions of Corporate Governance as stipulated in guidelines issued by DPE. The aforesaid certificate with the Directors' Report, which is sent annually to all the shareholders of the company, should also be included in the Annual Report. Chairman's speech in Annual General Meeting (AGM) should also carry a Section on compliance with Corporate Governance guidelines/norms and should form part of the Annual Reports of the concerned CPSE. The grading of CPSEs may be done by DPE on the basis of the compliance with Corporate Governance guidelines/norms.

CHAPTER 14

Corporate Social Responsibility

India is a country of myriad contradictions. On the one hand, it has grown to be one of the largest economies in the world, and an increasingly important player in the emerging global order, on the other hand, it is still home to the largest number of people living in absolute poverty (even if the proportion of poor people has decreased) and the largest number of undernourished children. What emerges is a picture of uneven distribution of the benefits of growth which many believe, is the root cause of social unrest. Companies too have been the target of those perturbed by this uneven development and as a result, their contributions to society are under severe scrutiny. With increasing awareness of this gap between the haves and the have-nots, this scrutiny will only increase over time and societal expectations will be on the rise.

Many companies have been quick to sense this development, and have responded proactively while others have done so only when pushed. Governments as well as regulators have responded to this unrest and the National Voluntary Guidelines for Social, Environmental and Economic Responsibilities of Business (accompanied by the Business Responsibility Reports mandated by the SEBI for the top 100 companies) and the CSR clause within the Companies Act, 2013 are two such instances of the steps taken.

There was no provision under the Companies Act, 1956 for corporate Social Responsibility (CSR). The Companies Act, 2013 for the first time has introduced a welcome provision vide Section 135, effective from 27th February, 2014 requiring corporate to mandatorily spend, in every financial year, at least two per cent of the average net profits calculated as per Section 198 of the Companies Act of the company made during the three immediately preceding financial years, on certain specified areas of social upliftment in discharge of their social responsibilities.

Broadly, CSR implies a concept, whereby companies decide voluntarily to contribute to a better society and a cleaner environment – a concept, whereby the companies integrate social and other useful concerns in their business operations for the betterment of its stakeholders and society in general in a voluntary way.

The Companies (CSR Policy) Rules, 2014 provides the exhaustive definition of CSR which provides that the CSR means and includes but is not limited to (i) Projects or programs relating to activities specified in Schedule VII to the Act; or (ii) Projects or programs relating to activities undertaken by the board of directors of a company (Board) in pursuance of recommendations of the CSR Committee of the Board as per declared CSR Policy of the company subject to the condition that such policy will cover subjects enumerated in Schedule VII of the Act.

Every company including its holding or subsidiary, and a foreign company defined under Section 2(42) of the Companies Act, 2013 having its branch office or project office in India, having (i) net worth of rupees 500 crore or more, or (ii) turnover of rupees 1000 crore or more (iii) or a net profit of rupees 5 crore or more, during any financial year shall constitute a Corporate Social Responsibility Committee of the Board, consisting of three or more directors, out of which at least one director shall be an independent director. The composition of the committee shall be included in the board's report. In case of an unlisted public company or a private company which is not required to appoint an independent director shall have its CSR Committee without such Director.

Any company which ceases to be a company for three consecutive financial years, or otherwise exempted from constituting committee, shall not be required to constitute a CSR Committee.

The main functions of CSR Committee shall be to formulate and recommend to the Board, a CSR Policy, recommend the amount of expenditure to be incurred and monitor the CSR Policy of the company from time to time. Based on the recommendations made by the CSR Committee, Board approves the CSR Policy for the company and disclose contents of such Policy in its report and also displays it on the Companies website, if any, in such manner as may be prescribed; and ensure that the activities as are included in CSR Policy of the company are undertaken by the company.

The company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for CSR activities. The Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years However, such expenditure shall not exceed five percent of total CSR expenditure of the company in one financial year.

As per schedule VII of the companies Act 2013, activities to be undertaken under CSR policy includes; (i) eradicating hunger, poverty and malnutrition, promoting preventive health care and sanitation and making available safe drinking water; (ii) promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly, and the differently abled and livelihood enhancement projects; (iii) promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups; (iv) ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agro forestry, conservation of natural resources and maintaining quality of soil, air and water; (v) protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts; (vi) measures for the benefit of armed forces veterans, war widows and their dependents;(vii) training to promote rural sports, nationally recognised sports, paralympic sports and Olympic sports;(viii) contribution to the Prime Minister's National Relief Fund or any other -fund set up by the Central Government for socio-economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; (ix)contributions or funds provided to technology incubators located within academic institutions which are approved by the Central Government; (x) rural development projects.

The Companies (CSR Policy) Rules, 2014 provides that any CSR projects or programs or activities undertaken outside India, or activities that benefit only the employees of the company and their families and contribution of any amount directly or indirectly to any political party under Section 182 of the Act shall not be considered as a CSR activity.

CHAPTER 15

International Financial Reporting Standards (IFRS)

A reliable, consistent and uniform financial reporting is an important part of good corporate governance worldwide. Different countries have different sets of Accounting Standards to regulate financial reporting by their corporate sector. However, with the advent of globalization, investment beyond the boundaries and trading has increased. The investors, therefore, need a uniform globally accepted set of Accounting Standards followed by companies so that comparison across the companies globally is facilitated.

Many countries including India have responded favourably to these requirements. The International Accounting Standards Board (IASB) has been recognized as global Accounting Standards setter. International Financial Reporting Standards (IFRSs) formulated by IASB has been adopted by more than 100 countries (including countries of European Unions, Australia, New Zealand, Pakistan, Sri Lanka). Many other countries are expected to either adopt IFRSs in entirely or converge their own standards with the standards issued by IASB. There was commitment in G-20 summit held in September 2009 that G-20 Countries (of which India is also a member country) would converge national Accounting Standards with IFRS by June 2011.

Convergence to IFRS in India

In India, the process of convergence with IFRS has been primarily carried out by Ministry of Corporate Affairs (MCA) through wide ranging consultative and participative exercise with all the concerned stakeholders

Conversion is much more than a technical accounting issue. IFRS in India may significantly affect a Companies day-to-day operations and may even impact the reported profitability of the business itself. Conversion brings a one-time opportunity to comprehensively reassess financial reporting and take ‘a clean sheet of paper’ approach to financial policies and processes.

The Convergence process, however, has proved to be a great challenge for India. India had to defer the implementation of converged accounting standards number of times. In recent past, number of Indian Accounting Standards have been converged with IFRS but the date of implementation of the same was not notified by the Government pending requisite changes in corporate laws, tax laws and other relevant regulations. These standards were called ‘Converged Indian Accounting Standards’ or ‘IndAS’.

There are certain deviations in ‘IndAS’ from IFrs However, few deviations are unavoidable due to the regulatory and legal framework as well as business practices which are peculiar to economic environment in India. Further, many IFRSs are undergoing revisions and few new IFRSs are under drafting stage, which are expected to become effective in the near future. Hence, the convergence with minimum deviations has to be a continuing process, if aimed to derive full benefits of the convergence.

The Ministry of Corporate Affairs (MCA) had earlier notified IndAS converged with IFRS in 2011, but the IndAS were not notified. Since then the Parliament has passed the new Companies Act, 2013. The new Act has introduced various new provisions, including requirement to prepare Consolidated Financial Statements, which would facilitate implementation of IndAS converged with IFrs In July 2014, the Finance Minister in his Budget speech proposed the adoption of the new Indian Accounting Standards (IndAS–the converged IFRS standards) by Indian companies voluntarily from FY 2015-16 and mandatory from FY 2016-17.

The Council of the ICAI, at its meeting, held on March 20-22, 2014, has finalised the roadmap. The revised roadmap recommended IndAS to be implemented for the preparation of Consolidated Financial Statements of listed companies and unlisted companies having net worth in excess of Rupees 500 crore from the accounting year beginning on or after 1st April, 2016, with previous year comparatives in IndAS for the year 2015-16. The stand-alone financial statements will continue to be prepared as per the existing notified Accounting Standards which would be upgraded over a period of time.

Finally, the Ministry of Corporate Affairs of the Government of India has notified on 16th February 2015, all the Indian Accounting Standards (IndAS) converged with IFRS after formulation thereof by the ICAI and their review by the National Advisory Committee on Accounting Standards (NACAS).

Consequent upon notification of converged IndAS, Companies and their auditors are required to comply with the Indian Accounting Standards (IndAS) in preparation of their financial statements and audit respectively, in the following manner.

Effective date of Implementation (financial year)	Classification of Company
1st April, 2015 onwards (With the comparatives for the periods ending 31st March 2015, or thereafter)	Any Company on voluntary basis
1St April, 2016 onwards With the comparatives for the periods ending 31st March 2016, or thereafter)	(a) Companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of rupees five hundred crore or more; (b) companies other than those state above (a) and having net worth of rupees five hundred crore or more; holding, subsidiary, joint venture or associate companies of companies covered above (a) & b as the case may be;
1st April, 2017 onwards With the comparatives for the periods ending 31st March 2017, or thereafter)	(a) companies whose equity or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than rupees five hundred crore; (b), unlisted companies having net worth of rupees two hundred and fifty crore or more but less than rupees five hundred crore. (c) holding, subsidiary, joint venture or associate companies of companies covered under above

Indian company which is a subsidiary, associate, joint venture and other similar entities of a foreign company shall prepare its financial statements in accordance with the Indian Accounting Standards (Ind AS) either voluntarily or mandatorily if it meets the criteria as specified in sub-rule (1).

Any company opting to apply the Indian Accounting Standards (Ind AS) voluntarily as specified in sub-rule (1) for its financial statements shall prepare its financial statements as per the Indian Accounting Standards (Ind AS) consistently.

Once the Indian Accounting Standards (Ind AS) are applied voluntarily, it shall be irrevocable and such companies shall not be required to prepare another set of financial statements in accordance with Accounting Standards specified in Accounting Standards, Rules, 2006.

Once a company starts following the Indian Accounting Standards (IndAS) either voluntarily or mandatorily on the basis of criteria specified in sub-rule (1), it shall be required to follow the Indian Accounting Standards (IndAS) for all the subsequent financial statements even if any of the criteria specified in this rule does not subsequently apply to it.

The insurance companies, banking companies and non-banking finance companies, for the time being exempted from applying the converged Indian Accounting Standards (IndAS) for preparation of their financial statements either voluntarily or mandatorily.

Following table indicates the IFRS viz-a-vis IndAS.

IFRS/ lAS No.	Corresponding Indian Accounting Standard	Name
IFRS I	lnd AS 101	First-time Adoption of Indian Accounting Standards
IFRS 2	Ind AS 102	Share-based Payment
IFRS 3	lnd AS 103	Business Combinations
IFRS4	lnd AS 104	insurance Contracts
IFRS 5	Ind AS 105	Non-current Assets Held for Sale and Discontinued
IFRS 6	lnd AS 106	Exploration for and Evaluation of Mineral Resources
IFRS 7	lnd AS 107	Financial instruments: Disclosures
lFRS8	lnd AS 108	Operating Segments
IFRS 9	lnd AS 109	Financial Instruments
IFRS 10	lnd AS 110	Consolidated Financial Statement
IFRS 11	lnd AS 111	Joint Arrangements
IFRS 12	lnd AS 112	Disclosure of Interest in Other Entities
IFRS 13	lnd AS 113	Fair Value Measurement
IFRS 14	lnd AS 114	Regulatory Deferral Accounts
IFRS 15	lnd AS 115	Revenue from Contract with Customers
lAS I	Ind AS I	Presentation of Financial Statements
lAS 2	lnd AS 2	Inventories
IAS 7	Ind AS 7	Statement of Cash Flows
lAS 8	lnd AS 8	Accounting Policies, Changes in Accounting Estimates
lAS 10	lnd AS l0	Events after the Reporting Period
lAS II	lnd AS II	Construction Contracts
lAS 12	lnd AS 12	Income Taxes
lAS 16	lnd AS 16	Property, Plant and Equipment
lAS 17	lnd AS 17	Leases
lAS 18	Tnd AS 18	Revenue

lAS 19	lnd AS 19	Employee Benefits
lAS 20	lnd AS 20	Accounting for Government Grants and Disclosure of Governement Assistance
IAS21	lnd AS 21	The Effects of Changes in Foreign Exchange Rates
lAS 23	Ind AS 23	Borrowing Costs
lAS 24	lnd AS 24	Related Party Disclosures
lAS 26	lnd AS 26	Accounting and Reporting of Retirement Benefit Plans
IAS27	lnd AS 27	Consolidated and Separate Financial Statements
lAS 28	lnd AS 28	Investments in Associates
lAS 29	lnd AS 29	Financial Reporting in Hyperinflationary Economies
lAS 31	lnd AS 3 1	Interests in Joint Ventures
lAS 32	Ind AS 32	Financial Instruments: Presentation
lAS 33	lnd AS 33	Earnings per Share
lAS 34	Ind AS 34	Interim Financial Reporting
lAS 36	lnd AS 36	Impairment of Assets
lAS 37	lnd AS 37	Provisions, Contingent Liabilities and Contingent Assets
lAS 38	lnd AS 38	Intangible Assets
lAS 39	lnd AS 39	Financial instruments: Recognition and Measurement
IAS 40	Ind AS 40	Investment Property
IAS 41	Ind AS 41	Agriculture